

Securities Industry



Trends

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Tax Reform 1986: A New Ball Game
for the Securities Industry & Its Customers

A Summary of Presentations
at SIA's Conference on Tax Reform

The 1986 Tax Bill represents a dramatic restructuring of the tax code that will affect every investor, investment product and securities firm. SIA's Conference reviewed the new rules in general, specific product and market challenges, and retail customer opportunities. In addition, the technical and compliance impacts of the bill on the securities industry were discussed as well as the ramifications for New York State and City taxation. This Trends issue summarizes and highlights presentations on these issues.

THE NEW RULES...AN OVERVIEW

Washington Perspective

Stephan K. Small

Securities Industry Association

The history of the 1986 tax bill is a strange one. Despite the fact that almost every taxpayer believes his taxes are too high and the tax code incomprehensible, the tax bill did not result from a popular ground swell of support. Nor was it the result of pressure from special interest groups. Neither the business community nor labor had much to say on the tax bill initially. As for the Congress, they seemed more eager to get rid of the problem of tax reform than to enact actual tax legislation.

Tax reform began with an odd ideological marriage between a conservative and liberal goal. The conservatives wanted to build on the 1981 tax cuts and the liberals wanted to close loopholes. But the real political start was a ploy -- not to push tax reform but to duck the issue of taxes in the 1984 elections.

For a variety of reasons, the 1981 tax cuts did not increase savings as projected and, in part, contributed to the disappointing increase in the deficit. The President's political advisers felt a discussion of taxes during the election campaign would be a strong negative. Thus, in a brilliant ploy, the President announced that Treasury would do a comprehensive review of the entire tax code, with recommendations to be announced after the elections. The Democrats, not wanting to talk about taxes in 1984 either, also endorsed the concept of tax reform.

We wound up with Treasury I, which immediately drew bad reviews but which the final tax bill mirrors. As to the politics, very few politicians embraced the concept enthusiastically. However, no one wanted tax reform to die on their doorstep. As much to avoid the downside and more so than to advocate the bill, the Ways & Means Committee passed the legislation. In the Senate Finance Committee, the bill fell apart but came together again.

This will not be the last tax bill. There will be another one depending on what happens to the economy. If we have problems, then the chance of restoring some targeted savings and investment incentives would be improved. If everything goes along well, the chance of restoring specific incentives will not be as good. There is, however, great skepticism. The next couple of years will be very challenging. By the next Congress, the securities industry hopefully will develop a consensus on how to restore incentives for savings and investment.

Economic & Market Effects
Allen Sinai
Shearson Lehman Brothers Inc.

The tax bill, with its tremendous change to the tax system, will have a lot of unknown effects in the next few years. Based on the criteria of equity, efficiency and simplicity, the new tax system is fairer than the old. For the household sector, the affluent, particularly those who most use loopholes, are taxed more, while the poor are taxed less. The same holds true for big versus small businesses. Certainly, the bill is a flatter tax. In terms of efficiency, the bill removes loopholes and subsidies. No doubt the economic system will be more efficient in this sense, but the question is what kind of gains from this efficiency will accrue in the macroeconomic sense. Just by virtue alone of removing 6 million people from the tax rolls, the system is more simple.

The fourth criteria for judging a tax system -- macroeconomic impact -- is the biggest unknown. The tax bill is revenue neutral on paper, with a \$121.5 billion tax cut for individuals and a \$120.5 billion tax increase for business. If the tax bill is, in fact, revenue neutral and that can involve errors of \$10-\$20 billion, then it will be essentially growth neutral. On average, the economy will not grow much faster nor slower than it would have under the old tax system. Moreover, the bill will probably be inflation neutral.

The main economic impact of the tax bill is compositional. The pattern of growth will be affected year-by-year, not on average over the next five years. The compositional effects of the bill will be felt via a new reverse trickle down theory. Money is taken from business and given to consumers. Households will have much more discretionary income. Our calculations show that over the next five years, 80% of the tax cuts for individuals will be spent and 20% will be saved. In this type of economy, that 80%, about \$95-\$96 billion, is a lot of consumer spending over five years.

The monies will flow back to the business sector. Some will also leak abroad. The pattern of consumer spending we see suggests that a lot of monies will be spent on non-durable goods and services, not so much on big ticket items or in areas related to the big capital-intensive business from which most of the funds were taken. The \$25 billion in savings will be used to pay off debt or to invest. For the financial services industry, there will be a very large increase in the volume of funds to compete for.

Thus, the flow of monies in the reverse trickle down theory moves from business to consumers and back to business. With lags, the trickle down works and business becomes vibrant

again. However, that is a question mark, especially since so much money leaks abroad.

Economywise, the bill raises \$11 1/2 billion in 1986 through retroactive elimination of the investment tax credit. Next year, there is a \$10 billion decrease in taxes for individuals and a \$20 billion increase for corporations. Hence, the bill would tend to restrict economic growth in 1987. In addition, it is an added recession risk for the economy next year, particularly in the first half because the restraining effect will hit an already troubled business sector. As for consumers, as their spending typically lags, we do not expect much spending from the tax cuts until late in 1987. Thus, the bottom line on macroeconomic effects over time: the tax bill is a negative for the economy next year and a positive in 1988 and 1989.

For the trade sector, it is hard to see anything in the bill that helps with our large deficit. In fact, it ought to make the deficit worse. Of the monies that go to consumers, about 10% leaks abroad. A few years ago the leakage was estimated at 4%-5%. The bill will not help U.S. business compete better in international markets.

As for the financial markets -- the fixed income and stock markets, we would expect interest rates to go down based solely on the tax bill. Because of lower marginal rates, the after-tax return on savings rises and the after-tax cost of borrowing rises. Theoretically, monies should flow into savings and away from borrowing, allowing nominal interest rates to decline slowly. If all things were equal, the bill would be a push towards lower interest rates. However, there are a host of other factors that determine interest rates -- inflation, growth, the Federal Reserve, how the dollar behaves, etc.

For the equity markets, the impact is mixed. The best deal around in an investment sense is ordinary income. Nevertheless, the income effect will make much more monies available for investment in stocks and bonds. The offset is that investor preference will be for high income, high dividend yielding securities. Given the change in the capital gains treatment, it will be more preferable for people to go into safe, sure returns rather than high beta stocks.

On a fundamental basis over 5 to 10 years, the value of the stock market should not be hurt by this bill. In the near term, the bill is a definite negative for the stock market because of: 1. the taking of capital gains between now and the end of the year; 2. the added recession risk to the economy in the first half of next year; and 3. general uncertainty over the total effect of the bill.

In addition to the reverse trickle down theory, there are two other ways the bill is supposed to work. One, there should

be an outpouring of supply-side work effort. Two, hidden revenues, such as in the underground economy, surface. Thus, there will be less need to raise taxes in the future to solve the deficit problem. However, the system will offset these trends by working through innovation in the allowable tax avoidance methods.

In summary, the tax bill is another big experiment of the Administration. Somehow their moves always seem to work out right. So, I am upbeat about the tax change.

Implications for the Securities Industry & Its Customers

Herman M. Schneider
Coopers & Lybrand

In 1987, there will be a 38 1/2% top rate for individuals and a 28% capital gains rate. In 1988, while there is a 28% top individual rate, there is a middle income bracket (\$71,900-\$149,250 joint) that is hit with a 33% rate. In 1987 and 1988, personal exemptions are going to \$1,900-\$1,950. However, it appears that if dependents are claimed because they are going to college, they lose their own exemption. In addition, at a certain upper income point, the personal exemption is phased out. It is in the income group, about \$100,000-\$200,000, that tax planning will become problematic.

The issue of whether or not to sell your stocks, given the increase in capital gains taxation, is very important. In most cases, it makes sense to sell stock now and buy it back. However, each individual's tax situation should be carefully analyzed and his investment expectations considered.

It is false that you are in the alternative minimum tax (AMT) because of capital gains. If you live in certain states with a 20% capital gains tax, the AMT of 20% makes the tax neutral. However, if you live in New York City, investors are subject to the AMT because of the State tax burden on the gain. If you are subject to the AMT in 1986 because of other tax preferences, it may not pay to take capital gain in 1986 and create an additional State tax burden which will not be deductible.

My class in tax law came to the conclusion that 60% of the Internal Revenue Code would disappear if they did away with the capital gains tax. Take note: the Conference Committee Report states that the entire capital gains structure is being kept specifically in order to allow for rate increases. I predict rates will go up and by 1990, the top rate will be 40%. On the other side of the coin, losses are deductible only to the extent of \$3,000. However, now you get one for one, instead of one for two.

In terms of itemized deductions, there is a 2% "flaw." Unreimbursed business expenses and the cost of preparing tax returns fall into miscellaneous deductions. For brokerage firms that charge investment advisory fees, the question becomes should they switch to a commission basis so that the commissions are deductible.

Focusing on a very important aspect of consumer interest, IRS examinations can be a problem. What should be done about client issues which are being challenged now, such as silver and gold straddles. Do you pay the interest now? If the interest is paid in 1986, it can be deducted at assume the 50% bracket if the AMT is not involved. In 1987, 65% will be deductible at a 38% bracket and the allowable portion gets lower the following year. Should you file the return and follow with a claim for a refund? There is good reason to consider settling with the IRS sooner rather than later.

Investment income and investment expense. In general, the income of an individual is broken into three parts: active, portfolio, and passive. There are definitional problems with both portfolio and passive income. It appears that the nature of income, i.e., dividends, interest, capital gains, is irrelevant. The source of the income -- what creates the income -- is more important.

As for tax planning, the basic concept is to defer income, except for long-term gain. The traditional ways of deferring recognition of gains are still available. Prepay your State tax unless you're in the AMT and prepay your real estate tax. Accelerate charitable contributions over the next several years to this year. Lastly, large purchases with big sales tax tickets should be made in 1986.

CURVE BALL...PRODUCT & MARKET CHALLENGES

Corporate Finance: Instruments of the Future

Steven D. Oppenheim
Oppenheim, Appel, Dixon & Co.

Here is what I believe will be the major changes in the types of entities that are in the public market. There will be increased options and futures, with more and more hedging opportunities accompanied by a like amount of problems. Also, foreign currency gains attributable to transactions will be taxed as ordinary income. Thus, a situation is possible where there is ordinary income on the currency component and capital loss from the overall economic result of a transaction. With capital loss only deductible to \$3,000 against gains, this impact will change the game for foreign currency transactions.

Because rates are going down, many people will decide not to take on capital risk for the same kind of after-tax return

offered by debt instruments with a greater degree of protection. Hence, a great many forms of debt instruments will be coming into the marketplace -- variable rate notes, participating notes, and the return of convertible bonds. Less risk to the investor, current deduction for corporations, current income to recipients -- these factors will fuel convertible issues. Moreover, there will be some interesting new features, like a variable conversion factor. In terms of accounting impact, corporations will be substituting the EPS question for the dilution problem, making for an interesting interplay of accounting and tax rules.

Even though there is an AMT problem for corporations, there will be an increase in the dividend paying securities that mirror money market instruments. These instruments will to some degree replace the basket trading strategies because they are easier to understand and more certain in effect. Remember, the tax bill has increased the concept of what is available to hedge.

With the increased difficulty of deducting interest expense, there will be less people playing the equity market on margin. More people will turn to debt instruments generating current income to offset margin interest expense, thus increasing the value of these instruments.

Finally, in response to the tax bill, the securities industry will come up with some of the most clever product and investment ideas seen in a couple of years. Those that are first with these new specific programs and tailored instruments will have an edge. However, intense competition has greatly shortened the period of benefit from innovation for the industry. It used to be 1-2 years, now it's only a couple of months.

Municipal Market

Joel R. Mesznik

Drexel Burnham Lambert Incorporated

Many of the issues concerning how the tax bill will affect the municipal market are unclear. However, the impact is severe in the long run. The PSA applied the regulations of the new tax bill as they are now understood to the municipal bonds issued in 1984. Of these issues, 41% could no longer be tax exempt. The municipal business is going to go down 40% according to these statistics, but ingenuity will mitigate some of that drop to 20% to 30% on the strictly municipal side of the business.

The long-term new issue market was about \$200 billion in 1985. Many of these issues were "private purpose" bonds, where much of the proceeds are used by private parties. All those bonds will be either eliminated or greatly restricted under the Act.

Looking to 1988 -- 1987 is too uncertain to estimate yet, we expect about \$100 billion in tax exempts. The reason for the severe drop is not just the tax bill. Much of 1985's volume was refundings, predicated on low interest rates. We don't expect to see that in the near future. The remaining portion of municipals, about \$20-\$30 billion, will be taxable bonds structured very much like corporate bonds.

The municipal market in 1988 will resemble the market of 1983, with very strong demand from retail investors and unit investment trusts. Retail will probably be about 50% to 70% of the total market. The new effective tax rates are not going to be very different for the typical municipal buyer than they were in the past. Banks will be as significant a buyer as they were in 1983 and some insurance companies will also be buyers.

As for municipal bond insurance, of the \$200 billion of municipal bonds issued in 1985, about \$47 billion or 25% was insured by the four large insurance companies in this business. If our volume drops in half, their premium is cut in half. In addition, the perception of risk that has made insurers such significant players in the municipal market has dropped. The need to have a triple-A rating has subsequently lessened. Moreover, the spread between a triple-A and a single-A municipal has declined from about 50 to 70 basis points two years ago to half of that right now.

Given a 250% discrepancy in insurers' high and low bids for a recent issue, it's obvious that they are having a problem identifying what their future market and business will be. There are two options. One, they can lower their premiums or two, they can change their business altogether and become more than just a municipal insurer.

In the last 90 days, we have seen about \$2 billion of taxable municipal bonds come to market. These have generally been triple-As, structured comparably to corporate bonds. That means a one-term maturity, in contrast to the serial issues of the municipal market. Municipal issuers will have to adjust to that. The municipal market in an average year may see three or four thousand issues, and each issue has serial bonds.

The taxable market will not be receptive to small issues. National markets will probably not accept issues of under \$100 million without penalty. Consequently, what may emerge is an attempt by small issuers to pool together to enter the national capital markets. Pools will probably be made up of similarly rated issues; blind pools where the money is raised first and then allocated to different issuers. In addition, there may be a warehousing mechanism by which investment banking firms or banks will purchase small issues, put them into one pool, and then sell a major pool.

So far, the buyers of taxable municipals have been the buyers of traditional corporate bonds, 50%-70% pension funds

and corporations and the remaining 30% foreign investors. Interestingly, all taxable municipals done so far have been under state names. Foreign buyers prefer to buy what they perceive to be sovereign credits and this has stirred great interest abroad. Retail investors will be attracted to the taxable municipal market because of attractive spreads. Right now, triple-A taxable municipals are about 135 basis points over the 10-year Treasury.

It will be interesting to see how firms handle the distribution of taxable municipals. Should they be done through the municipal desk and municipal sales force? Should the corporate desk price the issue and then turn it over to the municipal sales force? Different firms will use different approaches. All in all, there will be a lot to learn in the municipal market over the next two years.

Limited Partnerships & Direct Investments
Stephen J. Treadway
Smith Barney, Harris Upham & Co. Incorporated

The limited partnership and direct investment industry was not headed for good times prior to this tax bill. The 1984 tax bill killed some of the abusive aspects of our business and limited other legitimate aspects. At the same time, oil and gas, the major mainstay of the limited partnership business, did not perform. Hence, the industry in the last year and a half had backed itself into real estate as its primary means of support. However, we began to witness, and the press began to report about, a lot of overbuilding in real estate.

The 1986 tax bill has done for our industry what we could not do for ourselves -- it has changed the very nature of our business. There are two key overall effects. First, the value of excess tax losses in a partnership over the amount of cash that it actually distributes has been lost. Second, yield or cash has been made king. The business has gone from one of selling projections where cash flow begins in the future to one that will require an immediate cash yield if the deal is to be done. Our basic asset categories remain the same, only the pricing is affected by the bill. Real estate assets will have to drop in price. Deals that were done on a tax-driven basis will have to be resold on a cash-driven basis.

The two immediate effects of the bill in the long run mean that, without further legislative change, the limited partnership business will resume its growth and gain respectability. Respectability is important. In 1985, limited partnerships, excluding MLPs, raised \$15 billion of new equity. In contrast, the IPO market raised half that amount.

For many years, our industry has tried to get tabular representation or coverage in the Wall Street Journal. We will get that coverage in the future. Why? In one stroke, our business has become based on yield, is more simple and will be part of the fixed income market. Limited partnerships used to be sold in part on the quality of the tax opinion. No more tax opinion discussion; just yield and growth. The complicated structures of these partnerships will become for the most part a thing of the past. We will grow into the huge fixed income market.

There is one benefit -- a tax rate differential. A small corporation paying taxes at 34% may wish to change to a partnership paying 28%. Also, it would be advantageous for a leveraged buyout to use a partnership format, buy the assets and pay a lower tax rate. Almost every aspect of this business should grow. Our firm is doing more business this year than last in traditional areas because we switched to yield-oriented transactions.

The future looks bright. Caution, however, should be used in the "transitional deal," where an asset was bought or contracted for prior to passage of the bill and priced under the old bill but which will disguise itself as a yield deal in the new environment. The key to our new opportunities will be whether or not Congress delivers on the lower bracket for partnerships versus corporations and whether or not they try to take away the MLP format. Even without the MLP format, the traditional limited partnership business should grow for all the reasons described.

PLAYING TO THE FANS...RETAIL CUSTOMER OPPORTUNITIES
(Panel Discussion)

Robert N. Gordon, Twenty-First Securities Corporation
(Discussion Leader)

Richard J. Capalbo, Drexel Burnham Lambert Incorporated
Edward Soule, Edward D. Jones & Co.

Has the Tax Act of 1986 altered the marketing strategy of your firm? We began altering our strategy a year or more ago as we saw the changes coming down the pike. (Soule) We change our marketing plan regularly. The last time our marketing strategy underwent a major change was with the Tax Act of 1981, which affected our marketing strategy more than the current tax bill. The 1986 bill will probably prove investor positive but not to the extent of the 1981 bill. From our point of view, marketing changes evolve with the amount of after-tax income investors get to keep. (Capalbo)

In general, have you seen a lot of inquiry from customers about the new law and how it might affect their investments? What has your firm been doing to take advantage of this? We've experienced an avalanche of customer concerns. Some investors have been fence-sitting in the past 6 months and others, who

structured their finances on the old tax law, are in shock over the radical change. We've been focusing more on bringing brokers up to speed and have not as yet been sending much material to clients. (Soule) At the point where we were confident that Congress was serious about tax reform, we started publishing a monthly newsletter, pointing out what looked likely to pass and what customers should start thinking about. In addition, we started a major seminar program and met with thousands of accountants and attorneys to deal with "third-party questions." (Capalbo)

Have you had much interest in the sell-buy back strategy to take advantage of this year's lower capital gains rate? Both firms are advocating caution with the use of this strategy. For some investors the sell-buy back strategy may make good sense. Other investors, however, should weigh their long-term investment objectives.

In 1988, there will be a zero holding period for all investments. Do you think that will change the investment strategy of the retail investor? The philosophy that the patient investor is rewarded will probably maintain its validity. We think that the long-term investor will still be the larger market. (Soule) Since the economics of short-term trading have been much improved, some people will reevaluate whether a short-term trading strategy makes sense. There will be some new players in that part of the trading spectrum, but the change will not have a major impact on the average investor. (Capalbo)

Given new severe restrictions, is your firm still going to market IRAs? We absolutely will. A lot of our customers are going to qualify under the income restrictions, and also many of our customers are not covered by qualified retirement funds. (Soule) The idea of a systematic savings plan is a good one, no matter how much money one makes. There are people that will continue to save \$2,000 on a regular basis, even if they don't get the deduction. We will continue to market IRAs to these people, at least for a year. (Capalbo)

Do you think there will be more emphasis on products geared for retirement, such as deferred annuities? Our deferred annuity and single life premium business has surged in the last few months. Both of these products are being marketed as retirement savings plans and that business is primed to expand dramatically. (Soule) At this point, our position in life insurance products isn't very strong. It appears that certain life insurance products will take on increased value because there is simply no other product that will compete with them. We have commissioned a total reexamination of the types of insurance products we sell and we will be formulating a new marketing plan. (Capalbo)

Do you think there is still going to be interest in real estate and other tax-shelter type products? We believe there

will be continued interest in tax-advantaged products. We are reviewing everything we've sold to date, with an eye toward restructuring. The new bill creates a high regard for income through various types of techniques. There are plenty of opportunities. (Capalbo) For the past two years, the majority of our real estate has been economic-based investment. We see a continued interest in this business and are marketing strictly on a yield-cash basis. (Soule)

Do you think the new law will be a negative or a positive for firms in the real estate business? We believe our mortgage business will get a shot in the arm from the new law. We hope that many people, who in the past have borrowed on margin or on consumer-based terms, will now be looking to refinance their homes or to take out second mortgages. (Soule) That provision will be a big plus for the S&L's. We are far behind other firms already in the real estate business. Our lack of expertise in evaluating real estate would make it difficult to be competitive. Some mergers between mortgage-type companies and brokerage firms may result because of this change in the law. (Capalbo)

Do you agree that tax-exempt bonds are the only game left in town? Because of the Federal tax change, the state tax bill in certain states is going to become a much larger portion of the total tax picture. This will impact the investment patterns of people who live in these states. Much more so than in the past, different marketing strategies will be required for different states. Moreover, if the products can be made as attractive as munies, there is plenty of room left for real estate partnerships. (Capalbo) Our sales of munies have surpassed last year's level and we have increased our marketing efforts. (Soule)

The deductibility of margin interest will be changed somewhat under the new rules. Do you think it will have a major impact on margin accounts? We have positioned our margin business more as a loan business. In this respect, our competition is the local banks but our rates are lower. Initially, we could lose some margin business if for no other reason than the tax motivation is lost. (Soule) I think that margin activity will decrease a bit as people weigh the alternatives such as first or second mortgages. As for leverage via margin accounts, individuals may switch to other products in the futures or options markets. (Capalbo)

As a final note, what advice are you giving clients that call today? Take an inventory of where you stand in financial planning, where you want to be in the future and, considering the changes in tax law, plan how to get there.

THE HOME TEAM...SECURITIES INDUSTRY TAXATION

Presentation by
Randall K.C. Kau
Sullivan & Cromwell

The treatment of capital gains is the biggest item of impact on the securities industry not only for customers but for firms as well. It is not precise to say that capital gain is treated as ordinary income. The distinction between gains and ordinary income remains despite the absence of a differential. The most obvious point for firms and customers is that the allowability of capital losses remains the same, \$3,000.

Another example where this distinction is important relates to Section 1256(e)(2) of the Code, which allows for a hedging exemption from application of the straddle rules. One of the most interesting and as yet unanswered questions is whether or not a reverse situation will now apply where people are trying to achieve ordinary income or loss treatment. While the distinction on the preferential rate is gone, it appears all of the lore and law about what is and is not a capital asset remains in effect.

A second major point to be made on capital gain is the effective date, which is written in terms of "taxable years beginning after 12/31/86" and has some specific applications for this industry. For installment sales of appreciated property, to the extent gain would be recognized in years after 12/31/86, that gain would be subject to higher tax rates. Also, for fiscal year partnerships which have recognized capital gain, that gain will not be included in the income of the individual partners until the calendar year in which the fiscal year ends. This also applies to distributions of capital gain dividends from regulated investment companies. There are many nuances in the new law with respect to capital gains.

Another major item for the securities industry is that by and large, the 1986 Act has not significantly amended the straddle provisions. Section 263 dealing with cash and carry transactions, 1092 and 1256, the mark-to-market rules, all remain in the law despite the absence of the differential for long-term capital gain.

There are a few small amendments that the securities industry should note. One, there is an extension or further limitation on the qualified covered call exception that was obtained in 1981 for a situation where a stock is sold at a loss and the option gain is recognized in a subsequent taxable year before the taxpayer has held the position for 30 days. Two, a positive point, the law treats fees received on the

lending of securities and substitute payments as entering into the 263 formula, thereby diminishing the amount of interest expense capitalized. Three, for pre-1981 straddles, those losses will be allowed if they were incurred in a trade or business, or if the loss incurred in a transaction entered into for profit though not a trade or business.

There are some major changes concerning dividends. The 85% dividends received deduction is reduced to 80% for dividends received or accrued after 12/31/86. For individuals, the \$100/\$200 dividend exclusion is repealed. In addition, there are some new rules for determining whether a dividend received by a corporate shareholder is an extraordinary dividend. First, the one-year holding period before sale has been increased to a two-year holding period before the dividend announcement date. Secondly, the basis of the stock may not be reduced below zero. However, any reduction which would reduce the basis below zero would be recaptured on sale.

The determination of whether a dividend is extraordinary will still be made under the current law's 10% (5% for preferred stock) of adjusted basis test. However, a taxpayer will also be able to elect to determine whether the dividend is extraordinary by reference to the fair market value of the stock rather than to the basis. The new rules are effective for dividends declared after July 18, 1986.

Regarding these dividends, the 1986 Act makes significant technical amendments, which include the following: 1. A taxpayer may use the fair market value on day before ex-dividend date for dividends declared after date of enactment (October 22, 1986) to determine whether a distribution is extraordinary or not. 2. Except as provided in regulations, any redemption not pro rata to all shareholders or part of a partial liquidation are treated as extraordinary without regard to holding period. This is contained in a new Section, 1059(e), of the Code. 3. Qualified preferred dividends must also meet an extraordinary dividend test, based on whether the actual rate of return is greater or less than 15%.

Presentation by
Gerard A. Mangieri
Arthur Andersen & Co.

The new corporate alternative minimum tax (AMT) is no doubt the most far-reaching business tax provision in the new tax bill. The AMT is significant because it is, in effect, a second tax system that is parallel to, but separate from, the regular tax. The AMT broadens the corporate tax base and brings financial-accounting principles into the tax system by requiring that a portion of financial-statement income be included in the tax base. The message from Congress in

enacting the AMT is that all corporations with financial-statement income must pay some tax currently on that income.

Much of the AMT's significance lies in its rate. Whereas the prior add-on tax rate was 15%, the rate under the new alternative system is 20%. The relationship of the AMT to the regular corporate tax rate magnifies its importance. In 1988, the 20% AMT rate will be 59% of the 34% regular rate. The practical effect of this narrow spread between the AMT and the regular rate is that a relatively minimal amount of preferences or adjustments can trigger the AMT.

Under the new provisions, corporations that defer recognition of income for regular tax purposes must recognize the income sooner for the AMT. Of all the new provisions concerning the AMT, the general rule that one-half of book income in excess of alternative minimum taxable income (AMTI) be added to the AMT is most significant. This is not half of book income, but half of book income in excess of AMTI. Thus, the greater the disparity between book and tax accounting, the greater this adjustment. The book-income adjustment applies only in 1987, 1988 and 1989. After 1989, this income adjustment is replaced by the earnings and profits adjustment.

One particular item of note in calculating the AMT base: All tax-exempt interest attributable to private activity bonds issued after 8/7/86 is added to the AMT base as a preference. The new law, however, does provide a special rule for certain issues.

The new law introduces uniform capitalization rules. These rules will apply to assets held by a taxpayer in inventory or for sale to customers in the ordinary course of business. Thus, inventories of securities firms carried at cost will be subject to the capitalization rules. Certain costs will, therefore, be transferred from current deductions to inventory.

Historically, a taxpayer that sells an asset and receives some or all of the consideration in the form of a promise to pay in the future has been able to use the installment method to defer recognition of income and payment of tax from the sale until payments on the installment obligation are received. The new law prohibits the use of the installment method for certain specified types of transactions, one of them being publicly traded property. Hence, the use of the installment method is no longer permitted for sales of stocks or securities. The Finance Committee Report notes that for sales on an established securities market, in which cash settlement customarily occurs several days after the date on which a trade is made, gain or loss by either the cash- or accrual-method taxpayers must be recognized on the day the trade is executed. Therefore, this changes the long-standing rule that gains on the sale of stock or securities by individual taxpayers need not be recognized until the settlement date.

The securities industry, like all business, will have some adjusting to do in its spending on business meals and entertainment. The deduction for business meals and entertainment is limited to 80% of the amount that would otherwise have been allowable. In addition, the deduction for meals is now required to meet the same business-connection requirement that previously applied to entertainment expenses and lavish or extravagant expenditures are disallowed. In the way of entertainment, expenses for ticket purchases to the extent that they exceed the face value of the tickets are not allowable. As for skyboxes and other luxury seats at sports events, these are also disallowed to the extent the cost exceeds that of regular box seat tickets.

EXTRA INNING...RELATED ISSUES

New York State and City Issues

Simon Gold

Asiel & Co.

The State tax system largely conforms with the Federal system. By changing the Federal tax numbers with less in the way of deductions, the tax base will be broader for State purposes. The State is "terribly embarrassed" because it ends up with a windfall of about \$2 billion. Even the City is a "little embarrassed" with several hundred million dollars of windfall. Of the State's \$2 billion windfall, an estimated 94% is due to increased individual taxes.

What will happen to the windfall? While there is a general feeling the State will give back the windfall, there is the troublesome question of how the tax monies will be refunded. One State official has said: social policy may indicate that the windfall may not go back to those who paid it. At least half of the windfall comes from increased capital gains taxes. However, it seems it would be politically inexpedient as well as against social policy to give back money to those with capital gains because they are "rich".

Nevertheless, the increased revenues should be given back to those who have paid them. The Governor has asked a committee to devise a program to study the windfall, and SIA has formed an ad hoc committee to review what should be done. There is a simple way to fix the capital gains problem; i.e. continue to permit a 60% long-term capital gains deduction. In other areas, there may not be such simple solutions as almost every individual and corporation will be paying higher State taxes.

The City and State already have a tax problem without the windfall: a tax climate that motivates people to move out. Just bringing the situation back to the status quo is not the

answer. The State must come up with a program not only for directing the windfall but also to reform itself to some degree. However, the windfall will stymie consideration of State and local tax reform for awhile.

Although not yet final, the SIA has devised a broad based plan which calls for relief in capital gains taxation and reform of tax rates. Also included is a recommendation that the differential between unearned and earned income be eliminated. Next year, under the 4% differential, those people with unearned income will be paying 4% more than people with earned income. In the City tax area, the City still has the unincorporated business tax, even though this was dropped by the State several years ago. Perhaps the City will agree to drop this tax now. I hope that when all is said and done, a fair way of distributing the windfall will be found that encourages entrepreneurs and other highly motivated individuals to remain in New York.

Reporting & Compliance Issues
Thomas G. Vitez
Securities Industry Association

There are several items of note in the reporting and compliance area for the industry, three of them related to the new tax bill. The industry scored a victory in one provision of the tax bill -- the reporting of 1099 information. Firms will once again be allowed to furnish 1099 information on the annual statement, providing certain requirements are met. In terms of 1099 information, since taxpayers will have to start reporting tax-exempt municipal bond interest, firms will have to start providing this information to their customers as well.

Under the Senate bill, firms would have had major responsibilities in keeping track of deductible and non-deductible IRA accounts. However, the Conference bill places the responsibility primarily on the taxpayer. While firms will have to supply information regarding contributions and earnings, the taxpayer will have to calculate via a formula method the portion of each distribution which is a tax free return of capital compared to a return of dividend or interest.

Thirdly, a solution to the MLP compliance problem has been worked out. Firms will supply partnerships with the names of beneficial owners, thus avoiding the problem whereby the firm was responsible for taxes on MLP income for shares in Street name. A clearing center is being set up where firms will provide this information on a monthly basis. The clearing house will consolidate this information and supply it to the MLPs.

In terms of other items of interest, SIA testified that the original regulations on the withholding tax under FIRPTA were unnecessarily complex. We recommended that the withholding system should follow the traditional system of certification, W-8 or W-9, and that the broker should withhold the tax where holders are in Street name. Our recommendations will be incorporated in the regulations.

TIN penalty program issues are still under discussion. Our position is that government mismatches should be solved by government. If there are bona fide remaining problems, then the industry should offer assistance. The IRS is setting up a task force of staff and industry representatives to discuss problems with this program.

Another issue which is still "on the table" is the new reporting of OID on CDs. The IRS wants brokers to report OID not only on CDs they sold to a customer originally but also on CDs purchased in the secondary market or transferred in from another broker. We have recommended that the CD issuer be subject to Form 8281 filing requirements, thus supplying OID information for inclusion in IRS' 1212 publication. If these CDs are incorporated in the 1212 publication, we will be able to comply with the new regulations. We are awaiting further word from the IRS on our recommendation.

Summaries prepared by:
Carolyn Hildebrandt
Assistant Vice President

VOLUME

	SEPT 1986	JAN - SEPT 1986	SEPT 1985	JAN - SEPT 1985	% CHAN. J-S 1986-1985
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	150.8	140.3	97.9	104.8	33.6%
AMEX (MILS.)*	10.8	12.2	7.0	8.0	57.8%
NASDAQ (MILS.)*	104.9	116.0	74.4	77.6	47.4%
REGIONAL EXCHANGE (MILS.)*	27.4	23.1	16.8	18.2	27.3%
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	\$124,844	\$1,023,761	\$66,237	\$691,539	48.0%
AMEX (MILS.)	3,191	32,600	1,591	18,523	76.0%
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	8,304	81,475	4,711	59,330	27.3%
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	16,716	161,118	11,694	135,779	19.7%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	47.9%	49.3%	52.3%	51.8%	---
CONTRACTS TRADED (THOUS.)					
CEOE OPTIONS	17,758	140,501	11,531	103,638	35.6%
AMEX OPTIONS	3,940	37,181	2,308	24,454	52.0%
COMMODITY	17,124	142,364	12,759	117,966	20.7%

*MONTHLY AVERAGE

N/A - DATA NOT AVAILABLE

YIELDS

(MONTHLY AVERAGES)

BOND BUYER INDEX (20 BOND)
CORPORATE BOND YIELDS (MOODY'S)
Aaa CORPORATE
Baa CORPORATE
RATIO Aaa CORPS. TO Baa CORPS.
MUNICIPAL BOND YIELDS (MOODY'S)

OCTOBER 1986	OCTOBER 1985	BASIS POINT CHG. 1986-1985
7.08%	9.05%	(200)
8.86	11.02	(216)
10.24	12.36	(212)
0.87	0.89	(3)
7.08	9.06	(200)

PRICES (END OF MONTH)

DOW JONES INDUSTRIALS
STANDARD & POOR'S 500
NYSE COMPOSITE
AMEX MARKET VALUE INDEX
VALUE LINE COMPOSITE
NASDAQ COMPOSITE

OCTOBER 1986	OCTOBER 1985	% CHAN. Y-T-D 1986-1985
1877.81	1390.25	35.07%
243.98	189.82	28.53%
140.42	109.65	28.06%
265.59	228.61	16.18%
230.44	195.04	18.15%
360.77	292.54	23.32%

UNDERWRITING

	OCTOBER 1986	OCTOBER 1985	% Change 1986-1985
CORPORATE FINANCING (Gross New Issues - \$ Mils)			
TOTAL	\$30,079.0	\$11,606.4	159.2%
Common Stock	\$4,285.3	\$2,026.0	111.5%
# of Common Stock Issues	114	70	62.9%
Preferred Stock	\$974.5	\$494.8	96.9%
# of Preferred Stock Issues	14	9	55.6%
Corporate Debt	\$24,819.1	\$9,085.6	173.2%
# of Corporate Debt Issues	153	91	68.1%
MUNICIPAL FINANCING (Gross New Issues - \$ Mils)			
Negotiated	\$7,427.1	\$17,341.3	-57.2%
# of Issues	153	429	-64.3%
Competitive	\$1,653.2	\$4,491.2	-63.2%
# of Issues	53	143	-62.9%

Source: IDD Information Services

RECENT INTERESTING READING AND STATISTICAL MATERIAL

<u>Item</u>	<u>Description</u>	<u>Source</u>
<u>Management & Professional</u> <u>Earnings in the Securities</u> <u>Industry</u>	Annual SIA survey which provides base salary and bonus information on 128 middle management and professional positions. The study is based on input of 63 SIA-member firms employing 117,000 individuals, thus representing almost 50% of total employment at SIA-member firms. Data presented include: year-end 1985 vs. year-end 1984 comparisons of salaries and bonuses, nationally and in NYC.	SIA Survey Department SIA member - \$400 Others - \$1,200
"Next Year's Tax Bill: Fix Capital Gains"	Author argues that the repeal of the long-term capital gain preference at the Federal level will probably be adopted at the state level as well. Thus, much higher rates on capital gains undoubtedly will cause many taxpayers to refrain from realizing gains. Immobility of capital will have a serious impact on the venture capital market. If these changes were done in the name of producing revenues and income redistributions, legislators are in for a rude awakening. Author urges restoration of the preference for capital gains and, at the very least, indexation of gains.	<u>Tax Notes</u> <u>10/27/86</u>
"Nomura Securities Global Ambitions"	Although Nomura is the world's largest securities firm with 4 million retail customers and a capital base of \$3.17 billion, it lags behind its competitors in international investment banking. Article reviews problems Nomura faces in climbing to the top position in international investment banking and the firm's plans to overcome this.	<u>Dun's Business Month</u> <u>November 1986</u>

"Diminishing Returns"

Brokerage firms are changing their compensation schedules regularly. Most have revised them downward over the last several years. The continual changes are putting a new kind of pressure on brokers and some see the changes as part of a move toward salaried brokers. Article reviews payout changes at various firms.

Registered Representative
October 1986

"The Americanization of
British Pensions"

A host of U.S. investment trends and techniques are transforming the management of U.K. funds. Article examines the two latest imports from America: indexing and the "beauty contest." While an estimated 25% of the U.K. equity market is indexed compared with 10% in the U.S., the massive British Railways pension fund is conducting an elaborate talent hunt for outside managers.

Institutional Investor
International Edition
October 1986

"Do Plan Sponsors Really Need
An Investment Manager?"

Article examines the degree of market efficiency (modern portfolio theory), then discusses the pros and cons of passive versus active money management. Concludes with a list of investor types who are better off using indexing as a portfolio management approach.

Investment Decisions
October 1986

"Recent Developments in
Corporate Finance"

Reviews the recent trends in balance sheets of nonfinancial corporations, considers the contributions of new markets and products to these trends, and assesses the implications of these markets and products for the future. Concludes: With the increased R&D of new financial instruments plus deregulation in foreign financial centers, the pace of financial innovation is unlikely to slacken.

Federal Reserve Bulletin
November 1986

"How Did your Mutual Fund Do?"

Quarterly ranking of mutual fund performance based on Lipper Gauge. Extensive coverage of third quarter results, including sector funds, top three managers over time, and foreign-bond funds.

Barron's
11/10/86



AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
Produced by the SIA Research Department

Vol. XIII, No. 1

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OPPORTUNITIES IN THE 1990s

A Summary of Presentations at the 1987 Trends Conference*

The theme of the 1987 Trends Conference was "Opportunities in the 1990s." The day's conference featured various senior brokerage industry executives addressing the future of Wall Street and brokerage firms for the next decade. Topics ranged from perspectives about the overall opportunities available to brokerage firms in the capital and retail markets to specific subjects such as globalization, new products in the capital markets area, and firms taking principal positions in their own deals.

In addition to projected changes in the capital markets, the afternoon session reviewed overall changes in the retail markets, market segmentation and asset gathering, and the outlook for traditional and packaged products. One of Wall Street's leading spokesmen concluded the day with his reflections on past changes and probable future changes as well.

This issue of Securities Industry Trends summarizes the conference speakers' remarks concerning opportunities in the securities industry in the 1990s.

* The full transcript of the 1987 Trends Conference is available for \$75. An order form is enclosed.

OVERVIEW OF CAPITAL MARKET CHANGES

George L. Ball
Chairman and Chief Executive Officer
Prudential-Bache Securities

If you just look at the here and now, it is relatively clear that the marketplace is in something of a state of frenzy. Unfortunately, today's environment is about as sustainable as the afterglow from the third martini.

For now, however, the demand for shares is going to be augmented enormously by two important new sources, one from the east and the other from the rest.

Now, the new demand from the east is clearly the Japanese. The Japanese have begun to discover the U.S. equity markets. The other big source of increased demand, the rest, is the individual investor. In 1986 the strength in the market was in the blue chip institutionally dominated stocks. Now the trend has begun to shift rather rapidly, in another direction. The individual likes small cap stocks and lower price stocks. Also dead ahead, is a potential crisis. We may well run a very serious test of the industry's operations and execution capability.

We may indeed be over-confident of our ability to process, to execute, and deliver clean statements to clients promptly if volume really mushrooms and the individual comes back on an exponential basis.

If we get into a processing crunch, bankers are going to be quick to boast of their prowess in terms of an ability to crunch paper. So what's paramount is that we avoid a problem in the first place.

On the capital markets side, the big Mount Everest type of change is that firms are going to have to put their own financial resources at risk with far greater frequency than ever in the past.

Similarly, investment banks used to simply facilitate mergers and acquisitions. Nowadays, they have to be willing to put their own dough on the line. In other words, firms are being forced to become traders in whole companies rather than simply traders in stocks. This means two things -- greater risk and squeezed profit margins.

On a different front, costs have gone up far too far. In 1986, personnel costs rose by 30%, and non-personnel costs were up 25%. That is both unacceptable and unsustainable. A bull market is once again creating a fixed cost base which is impossible to contract rapidly enough when things slow down.

Longer term, what else lies ahead? In the late 1980s to early 1990s, a big trend which is going to take place is the re-equitization of American business. American business has never been as highly leveraged as it is today and that is a fool's paradise. When the economy falters or interest rates rise, the debt is going to become too heavy a weight for the leveraged balance sheets to bear. Therefore, a solution needs to be found and the good news is they are going to need to turn to us to revitalize their balance sheets with equity.

Another big revenue source for which most of us are ill-prepared is currencies. Currencies are perhaps the biggest development on the investment horizon. Clients need access to currency capabilities for a variety of risk avoidance reasons. As currency swaps become as commonplace as interest rate swaps have been, I think you're going to see a flocking to cross-border, cross-currency opportunities.

The big revolution, in the retail business, is that account executives will increasingly take on the role of investment manager for households. As part of the process of the metamorphosis, by 1991, performance fees will begin to permeate the retail sector. Retail brokers will have to produce attractive investment results for their clients or they're going to be paid like discount brokers. Packaged products, like mutual funds and limited partnerships, are going to wane while in the higher risk areas, like mezzanine equity, technology, and high beta stocks, they will wax mightily. Also, by 1990, the maximum tax rate will be 40% plus or minus. As a result, pure tax shelters are going to rise again like Phoenix out of its own ashes.

Globalization and Merchant Banking

David C. Batten
Executive Director
Credit Suisse First Boston

There are six components of globalization: deregulation, information, computerization, innovation, securitization and disintermediation.

Governments and regulators around the world, over the past five years, have eliminated barriers to entry for foreign intermediaries, have expanded the range of activities they can legally pursue, have relaxed or abolished interest rate ceilings and foreign exchange controls, and have expanded the range of investment vehicles in which local market participants may deal.

One of the results is that the competitive oligopolies in many national markets have and are continuing to break down.

In the Euromarket, the top five firms had a 45% market share in 1982, but only a 35% market share last year. Over the same time frame, the development of high speed on line systems, and new and more flexible software, have allowed faster, if not instantaneous, collection, manipulation and dispersion of massive amounts of data to market participants worldwide. We have seen an explosion of new products and structures which can be bundled and unbundled in an almost unlimited form to meet the specific requirements of investors and issuers.

Finally, in liquifying new assets such as mortgages, auto receivables and computer leases, and in creating new vehicles such as Eurocommercial paper, we have redirected significant amounts of savings flows and fundamentally changed the investment process around the world.

Also, during the past three or four years, nothing has had as dramatic an effect on capital markets as had the development of the swap mechanics. In part fueled by swaps, Eurobond and foreign bond new issue volume expanded from under \$70 billion three years ago to over \$215 billion last year.

In the past, new issue activity was substantially dependent upon the net financing needs of borrowers. Today, swap-induced dynamic management of assets and liabilities triggers capital market new issue volume which is independent of borrowers' net financing needs.

On the equity side, this globalization process has been slower but is now picking up speed with a vengeance. According to the SIA's own figures, net foreign purchases of U.S. equities in the first nine months of 1986 totalled \$18.3 billion. In 1985, it was \$4.9 billion and the previous full year record had been in 1981 when the number was \$5.8 billion.

It's also interesting to try and assess the impact of these developments on market participants. For example, let's look at a CFO who wants to raise intermediate-term fixed rate dollars. You go back 10 years, he had two options -- basically, public and private. But today, through interest rate and currency swaps, he has five dozen alternatives through securities and swaps -- more if we add synthetic approaches, and even more if we secure the possible securitization of assets which might serve to obviate the need for the fixed-rate financing in the first place.

In terms of financial intermediaries, the implications are staggering if a firm hopes to be a world class player in the 1990s. Competitive forces require that we invest in the people, the hardware and the software to generate the knowledge required to deliver these products. Less than a full service approach means we're vulnerable to losing transactions to a firm who's invested in a marketplace that we've ignored. Being fully competitive requires huge investments in the three major

markets which I would call packaging centers -- London, Tokyo and New York. It also requires providing as much computer capability to your mortgage and asset finance departments as would have been required to run your whole firm just a few years ago. Being fully competitive requires that you take risks as principal on an ongoing basis.

I defined a world-competitive investment bank today as being willing to take huge risks as principal in assets we call securities and swaps. One definition of merchant banking is an intermediary who takes risks as principal in corporate assets.

If properly conceived and structured, the revenue from the sale of these assets or from their financings can provide significantly better returns. The business of bridge financing seems to me a logical extension of our current recapitalization and M&A businesses, as does that of operating as principal in LBOs. The credit analysis and judgments on cash flows are key components of the due diligence we already perform. The new element of this equation is liquidity, and I would argue that if compensation is adequate the risk is acceptable and that, in fact, these kinds of merchant banking activities are compatible, if not complementary, to businesses in which we already engage.

NEW PRODUCTS IN THE CAPITAL MARKETS

Ronald D. Gallatin
Managing Director
Shearson Lehman Brothers Inc.

Starting in 1981, we had the evolution of the modern new product era in investment banking. It resulted from two very major factors -- partial deregulation of the industry and very high interest rates. I think one could almost call the 1980s the decade of unbundling and the first product would be the zero coupon bond. We then went from the zero coupon bond to what was referred to as either a cat, lion, tiger or cougar, which was the zero coupon treasury. The idea was to go take this wonderful piece of paper they had called a government bond and start cutting it up into little pieces. This is the classic case of unbundling. The last step was when we went back to the corporate market and created the serial zero. And this unbundling of the totality of the bond really started an evolutionary process. It went further on into areas like interest rate swaps.

Since issuers want to borrow at the optimum rate, we showed them that they can borrow cheaper in the Euromarket. They can borrow cheaper if they borrow in different currencies even though it may not be a currency they actually want to be borrowing in. What all of these pieces of a transaction are

doing is bundling itself back to the real piece of paper, a nice, standard piece of debt. When you're finished with the flow charts, what the CFO's mindset is, is that he went out and borrowed what he wanted to borrow and all these machinations are nothing more than getting him the lowest possible debt rate.

Next, as interest rates went all the way up, we found a tremendous amount of risk aversion, and this risk aversion had to be handled by the marketplace. Risk aversion can best be described by taking you through what happened in the preferred stock market during a period of the 80s.

The 80s started with something that was called fixed rate preferred. The problem with a fixed rate preferred stock from the buyer's standpoint was that if interest rates were to go higher, by definition, the value of that preferred stock went lower. So a creative product came up, and it was called adjustable rate preferred.

There was a formula that was used in the adjustable rate preferreds that as Treasury rates went up, the dividend rate went up. What we found out in the marketplace was that formulas are wonderful and they're always accurate the day that you price them at par, and they're always inaccurate approximately five seconds after you break syndicate or unfortunately sometimes before you break syndicate.

And we then went on to the next product, because the formulas didn't always work. We came up with an auction process for the dividend to be absolutely sure that it will always trade at par. We've started with whole animals called bonds, preferred stock, common stock, and bundled and unbundled them.

The difference that appears to be coming up for the 90s, once we get to full globalization, is that people are buying in markets that they're not totally familiar with. When this happens, I think you may see a reverse of the process. The buyer is going to say, "I don't understand all this, so I need a multitude of protections. Maybe some of my money should be in Swiss francs and some in dollars and I should be in banks of one country and in industrials of another country." As a result, whether they're done as funds or something as simple as old time converts, you're going to see a lot of transactions combining the various facets that we've been doing all the unbundling on.

I'd like to touch on two more areas. One is asset-backed financing. Now, asset-backed financing started off slowly. In the 1990s, this market will be hundreds upon hundreds of billions of dollars. The reason that this market started as slowly as it did is twofold. The first reason was that the rating agencies needed a lot of convincing of precisely how the formulas would work before they put a rating on it. They

needed a lot of work and a lot of hand-holding. A lot of that has been done and they have now geared up.

The second major factor is the fact that the marketplace doesn't like a security it doesn't understand, and that it can't trade. Until they could understand what the prepayments were going to be, they couldn't evaluate how long the piece of paper is. Now they can.

The reason why the 90s will proliferate asset-backed financing is one very simple reason: interest rates are not going to stay at the rate they are today. When rates are low, it's not worth it for the issuer to pledge his best assets to save 20 basis points. What is going to happen, is that rates are going to go a lot higher.

In fact, if we had developed these new products in the 70s and then we got to the interest rates of the early 80s, you would have seen nothing but asset-based financing.

The last item I would bring out would be commodity backed bonds with the interest rate and/or the ultimate principal repayment determined by the price of an underlying commodity. Corporate treasurers and CFOs have up until now always believed that their commodity was worth twice what it's selling at, so that you could never go and negotiate a transaction. I think you're going to start seeing inflation fears some time in this next cycle and people are going to remember the runaway numbers of the last cycle. You're going to have a lot of companies that are going to finally accept the hypothesis which is the clearest and most sound for the CFO of a company that has a commodity. That is, that if his income is going up, it's because his commodity price went up, and he can afford higher interest. On the other hand, if it turns out his commodity price goes down, he's going to need a lower interest rate.

Taking Principal Positions in Your Own Deals

James P. Gorter
Partner
Goldman, Sachs & Co.

Merchant banking can be defined as the practice of risking your capital. The reasons for this are to:

- 1) assist your clients in getting a transaction completed;
- 2) to generate earnings from the particular transaction for yourself.

The trend towards merchant banking, towards investing in your deals, really accelerated in 1986.

Most investment bankers today are really scrambling to ask themselves, is this something that we really ought to be involved in, and if so, how are we going to handle it from a conflict and from a management point of view. We're talking here about really three types of investment, each different, each equally important.

First is providing your client with an immediate credit facility. The second thing is to actually put up the money in terms of a bridge financing. And the third thing is to take a major long-term equity participation in the transaction itself.

If you're basically providing credit lines or bridge financing, you're going to have credit risk. I also think you have a liquidity risk, because you're tying your money up. You probably are taking some kind of a basis risk -- a mismatched risk between assets and liabilities -- and you're certainly taking a long-term market risk if you are providing financing which is not going to be funded out for an extended period of time.

When you get into the equity end of the business, you're beginning to take entirely different risks. You're taking operating risks, product risks, management risks, as well as long-term financial risks. And finally, you may be taking a reputation risk.

Why do we have the trend towards investing in merchant banking type activities? I think what we may be groping for is some new high-margin product that can offset the very high fixed costs we've built up if the world should turn against us, and I think that is probably not a healthy reason to go into it.

People also believe they can leverage their in-house talent by putting the people with expertise in corporate finance, M&A, etc., to work in this capital investment area. That has a certain amount of logic to it but there are some basic problems here. There's a conflict problem. The role of the investment banker traditionally has been the mediator between the users and suppliers of capital. When you begin to act as principal, there is a temptation to put your own interests ahead of your client's.

There's another type of conflict. We actually lost a client because we took a position in another firm's LBO and the first client no longer chose to do business with us because he felt that, in effect, we were a competitor.

But the conflicts to me are really not the thing that gives me the biggest pause. There are dangers of substantial losses and I'm not sure that an investment banking firm which is

leveraged 35 to 1, like we all are, can afford to put itself in a position of sustaining significant losses in any one transaction. If you're going to do just one or two transactions and have just one or two leveraged buyout investments, this may be alright. The problem arises if it becomes a trend, a competitive trend where everybody is trying to outdo everybody else, and people are driven to excesses.

In summary, this is a trend which we're going to have to deal with. It's here. There's going to be competitive pressure on all of us, and yet I am not sure that it is a healthy direction for the investment banking business to go in.

OVERVIEW OF RETAIL MARKET CHANGES

Richard Capalbo
Senior Vice President
Drexel Burnham Lambert Incorporated

The period from 1969 through 1980 was an underperforming time for the stock market. This helped the proliferation of other products because stocks were looked at as unattractive. Then, during the period 1978 to 1985, with extremely high yields available, many clients gave up the stock market entirely and simply went for double digit money market rates at no risk. Also, the individual retail client over this period of time has seen a dominance by the institutional market. This made him feel that things are so complex and that the institutions have such an advantage with all their technology and all their research, that maybe the best way to approach things is to go through packaged products and use professional money managers.

One additional change is that brokers are now starting to get very comfortable with mutual fund products. This is going to have an impact much greater than just on products. It's going to have an impact on broker loyalty and turnover. Many of them have invested in their firm's own funds, or vendor funds, where there's trail commissions and they lose the trail commissions if they leave. Another thing that's important is that the retail business used to be an agency business, and now it's very much a principal business. In order to be in this business you've got to risk firm capital if you want to be creating private label products and want to do sole underwritings.

That's a very expensive luxury, and it's so expensive that you're going to see it start to reverse. New entities will be coming into the financial markets as vendors of product for retail firms.

There's no reason in the world why the same thing shouldn't happen on the marketing side. My guess is that there's going to be a new firm in the next 10 years that does nothing but distribute the best products of many entities who produce products.

International investing -- when you think of the amounts of money that have been raised in mutual funds specializing in foreign investments, it's awesome. A couple of statistics: foreigners purchasing U.S. securities -- bought \$3 billion worth of U.S. stocks in 1964. They increased it to \$14 billion in 1977 and in 1983, foreigners bought \$134 billion worth of securities in the United States. In 1984, U.S. citizens acquired \$30 billion of non-U.S. securities.

Now, as far as changes in competition are concerned, I think that merging of financial institutions is still the story of the future. I also think that decreasing firm loyalty will somewhat hamper the financial supermarket approach that started several years ago.

I think you're going to see the consolidation of offices, you're going to start to see economies of scale. You've already begun to see many firms trying to make their offices larger and you've already begun to see account executive's payouts at the low end getting killed. That unproductive broker -- pay him so little that he leaves and goes somewhere else, and let's really pay that big guy real well because he's very profitable, and let's fill our offices with those guys. And also now, if one product is more profitable than another product, let's not pay the broker any more on that one. Let's make the extra margin. Let's make all payouts the same for all products.

Technology is the one story yet to be told. Firms are trying to compete on the basis of delivery of technology and that could be a factor in the future as our children of this computer generation go through training programs and really know how to use it.

MARKET SEGMENTATION AND ASSET GATHERING

Hardwick Simmons
Vice Chairman
Shearson Lehman Brothers Inc.

We see our mission very clearly. We're looking for the affluent. And we define that as roughly 17 million households in the United States who own about 70% of the financial products that we're interested in dealing with. What we've said is we're not going to reach for any other group.

Now, it's really not until we're 40 or so that as a group we begin to accumulate assets, and become of real interest to an asset manager. Before that we've owned a lot of insurance and liabilities, essentially to buy the few assets we needed while we were building our net worth. Our strategy, and perhaps it's a risky one, is to pick those people up at or around age 40, when they begin to accumulate the assets and need the other services that we can provide, as opposed to others in the financial services business who want to grab the individual from cradle to grave.

Once on board, what are your clients looking for? Our clients told us that the most important ingredient is a satisfactory relationship with their financial consultant. They'd rather have a good relationship than see their account be a top performer, because they think within a decent relationship that they will get decent performance. What about price? The price to our clients was 1/20th as important as the relationship they had, which simply goes to show that if we provide value, price is not an issue.

If we're going to go after that affluent group, we have to go after them with a philosophy that tends to their assets. About seven or eight years ago, it seemed pretty apparent to us that our business was an asset driven business, not a transaction driven one. The revenues that we produced were in direct relationship to the assets that we collected, and we could literally forecast what our gross revenues were going to be, based on the assets that we actually controlled. So we stressed asset gathering and changed the name of our account executive to financial consultant, to put in better perspective the relationship we sought to have with all of our clients.

We tell the account executive that the most important thing he can do before opening a new account is to maximize his penetration of the assets of the clients he already has on board. We leave too much on the table as an industry.

Also, the more access you give an individual to his money, the more money he'll give you, so we use a Central Assets Account. If he knows he has to call and fight, you will never see more assets than your individual FC needs to execute the trade on the table at the time. If, on the other hand, he has access through check or credit card to his entire balance with no call necessary, he'll put all those assets in there because he really does buy the convenience argument of a consolidated account.

What about incentives? We compensate our financial consultants with two basis points a year on their assets, and it's deferred and paid to them at the end of five years. You're paying them for what's in your interest as a firm.

Finally, you've got to have your whole organization aware of the value of assets.

First, start with the households. That's where it all comes from. How many households does the average one of your financial consultants have that is active on an annual basis? What are the average assets? What is the asset total that each of them controls? How many new households are being added on a monthly basis? And the only importance of that is, how many new dollars of assets are being contributed? Each of these should be indelibly marked in the minds of your financial consultants, your branch managers, et al, over a period of time, and it becomes a way of life. And finally, you have to relate that to monthly commissions because that's where it all ties in.

So as you can see, if you look at assets as a key to managing your way into the future, and you're willing to go at it with a total approach, it's a major strategy that can insure your health over the next five or ten years.

TRADITIONAL AND PACKAGED PRODUCTS

Donald E. Nickelson
President, PaineWebber Consumer Markets
PaineWebber Incorporated

If you look back, the traditional products were stocks, bonds, and some mutual funds. We're transaction oriented with the traditional products, and we generate commissions and trading revenue.

If you then look at packaged products, the basic difference is that they reach new client segments and provide new benefits to clients. They have reached into the client's savings. The traditional products really couldn't compete for the savings dollar of the customer but packaged products have allowed us to do that. The other thing that's happened is that clients look for professional management of their funds.

If you look at total revenue in the securities industry, in 1980 about 12 1/2% was made up of packaged product revenue. By 1986, it was almost 37%. So you can see that packaged products are growing very rapidly.

The compound annual growth rate for the industry of commission income has been about 6 1/2% since 1980. If you add commission and trading together, it's been 14%. If you looked at fee income, it's 32 1/2%, but fee income started at a very low base. The one that has really driven packaged products has

been mutual fund commissions -- 58% compounded annually since 1980. So it's going to be a very, very powerful part of our business as we go forward.

The Tax Reform Act is going to change some of the direction of packaged products and traditional products as you look forward. Investors' decision-making is going to change, because it's not going to be based as much on tax considerations as it is on investment considerations.

People are also going to be looking for double digit returns that they got hooked on in the late 70s and early 80s. We think that probably lends itself to packaged products. You're going to have master limited partnerships. You're going to have high-yield securities and we're going to package that and manage it more intensely. You're going to see more convertibles, you've got the alternative minimum tax so for municipal bonds we're going to create vehicles to package those for a segment of the market. We think generally it's going to be a big part of the market for a lot of firms, and is going to drive the package concept even further.

The other big thing that we see out of this tax act is life insurance as an investment. You're going to see all of the major firms or most of them in some kind of a life product where we can have our mutual funds wrapped in either a variable annuity or a single premium life product because that is the one place you can still have tax advantages.

The 35 to 45 year-olds in the 1990s are going to be a growth segment. They are basically looking for lending and insurance products.

The accumulator, that's a large part of all of our client bases, is going to grow very rapidly in that decade also, so that's going to be a real growth market and there will be both traditional and package products there.

The retirement market, or the people just getting ready to retire, 55 to 64, have a lot of assets and are going to be looking for different products. The last category is the post-retirement or the retired people. By the year 2000, this is going to be the largest group of very wealthy, affluent and well-educated people in the history of this country, so there's going to be a ton of money out there.

And what might some of the implications be of all this? For that younger group, it's going to be lending or insurance. Traditionally, the brokerage industry has not had products for that group but by 1990 we are going to begin to create products for that group. We don't have them today, but I think that's a segment that we'll be looking at and creating products for, and maybe it's more insurance.

The accumulator is probably going to be looking for some trading and some investing in products and we see the packaged products developing more than traditional ones.

The retirement planning group will want more products that are services and planning. We don't really have them today, but in our marketing we are trying to understand what they are, package them, put them together, because we think that it's a segment that we'll go after.

That last segment, the post retirement, that has all the money and is well-educated, is really looking for service. Maybe we can put together a package of securities and you're going to pay their bills when they travel. They're looking for convenience. Again, we don't have that package, but at least I can describe it and think about it. I think those are the kinds of packaged products that you'll see go forward.

Again, I believe that packaged products will continue to grow faster than traditional products and that this is not just a short-term phenomenon.

I think that these are the underlying reasons for that. First is tax change. Taxes will drive packaged products. The demographics of the 80s, late 80s and 90s, again I think will drive more packaged products. I also think the whole concept of managed money is one that won't go away. I think that convenience is going to be more and more important and you just can't get convenience out of traditional products. So I think packaged products are the winner.

REFLECTIONS ON WALL STREET

Donald E. Weeden
Chief Executive Officer
Weeden & Co.

At May Day, there was doom and gloom everywhere on Wall Street. Today is entirely different. I didn't see one down curve on any of those beautiful slides used today and I agree with them. I think the future looks good for our industry. I think it looks extraordinary. If you go back over the last 10 years and look at the numbers, you see that there was a quantum leap in almost every statistic, whether you're talking about volume on the New York Stock Exchange, capital in the hands of the brokerage firms, revenues or profitability. There was a ten-fold increase in all of those. I believe that we will have another ten-fold increase in all of those things across the board.

The competition that started in 1975 was combined with an extraordinary creativity that started back as soon as May Day was finished and everybody said, "we've got to get down and figure out how we're going to develop products that we can sell to people and be profitable if we lose all these commissions", and they went ahead and did it. The creativity and the expansion of products in the last 10 years is overwhelming, and I think that will continue in a heightened degree as we better use the technology that's available to us. I think that we're going to find that equities and bonds are a narrow area, as we already have, and that what we have done to make complex our particular industry over the last 10 years, is going to be magnified enormously by the opportunities that are going to be out there of switching from one currency to another, from bonds in one country to stock in another, and so forth. If you take a look at it, it goes beyond geometrical progression.

That trend doesn't mean that the regional firms are going to be left out of it. All of this growth and complexity and demand on companies isn't going to ever take away that one extraordinary thing that they have, and that is the closeness to their customers.

I don't mean to say that there aren't any problems in the future. I've been a dealer all my life, I felt that taking risk and providing that service always deserved a higher rate of return than being a broker. The mix of customers are forcing the street to become more and more of a dealer and it is a more profitable business line. Those are good reasons to do it.

Some of the negative reasons are the enormous competitive pressure that there is to become a dealer. I think that indicates signs of getting into some future trouble. I think that this drive for market share is another disturbing thing, because I think people are going to be doing, over the next 10 years, a lot of the things that as a businessman they really wouldn't want to do, but they justify it in terms of market share. There is going to be a leveraging in dealing that may go beyond what is responsible.

I think that when investment banking firms begin to get into LBOs and commit a great deal of their capital and have this enormous opportunity to borrow from the banks, there will be enormous profit in that business for a while. There will be enormous competitive pressure, market share tendencies and so forth, and we're going to find that there is leverage in this marketplace that is not a great deal different than the leverage that was in the marketplace in the 20s.

This market is going to continue for a while and it will gather like a fire storm. We'll jump on the bandwagon and then

it will stop. It's going to stop like a car when you put on the brakes and we've got an awful lot of leverage out there -- we could have a real problem.

But all of the other major trends -- which include dealerization, globalization, technical advances, creativity, complexity of the markets, deregulation, the coming together of accounting procedures throughout the world -- are benefiting us all. The one really positive thing is that the amounts of monies that will be available to buy the products that we are primarily involved in, and are very good at developing and marketing, and know a lot about, is going to continue to increase both at the retail and the institutional level. And it can be that kind of swelling up that will save us all from a lot of mistakes that we might make along the way.

I would caution everybody to keep reminding yourselves that we're here to service somebody. If we can do a good job of that, then we can make a reasonable return on our time and effort. If we get greedy and forget about that servicing, and get caught up with the game of monopoly that we're all playing, and we become more and more detached from the realities that underlie our economy, then I think that we have troubles. If we can avoid that in our own thinking, both managers and people who are out there on the firing line, then I think we've got an enormously exciting, profitable decade ahead of us.

VOLUME

DEC 1986	JAN - DEC 1986	DEC 1985	JAN - DEC 1985	% CHAN. J-D 1986-1985
AVERAGE DAILY SHARE VOLUME ON				
NYSE (MILS.)*	141.0	133.4	109.2	29.1%
AMEX (MILS.)*	11.8	13.0	8.3	42.2%
NASDAQ (MILS.)*	113.6	106.0	82.1	38.4%
REGIONAL EXCHANGE (MILS.)*	N/A	23.1	18.8	N/A
DOLLAR VALUE OF SHARES TRADED ON				
NYSE (MILS.)	\$1,374,350	\$102,773	\$970,479	41.6%
AMEX (MILS.)	43,649	2,303	26,710	63.4%
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	108,517	7,728	78,820	37.7%
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	220,640	19,431	184,470	19.6%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	49.9%	49.6%	51.7%	---
CONTRACTS TRADED (THOUS.)				
CROE OPTIONS	N/A	16,326	148,888	N/A
AMEX OPTIONS	65,443	5,573	38,288	70.9%
COMMODITY	N/A	13,459	158,695	N/A

*MONTHLY AVERAGE

N/A - DATA NOT AVAILABLE

YIELDS

(MONTHLY AVERAGES)

DECEMBER 1986	DECEMBER 1985	BASIS POINT CHG 1986-1985
6.86%	8.43%	(157)
8.49	10.16	(167)
9.97	11.58	(161)
0.85	0.88	N/A
6.86	8.43	(157)

BOND BUYER INDEX (20 BOND)

CORPORATE BOND YIELDS (MOODY'S)

Aaa CORPORATE

Baa CORPORATE

RATIO Aaa CORPS. TO Baa CORPS.

MUNICIPAL BOND YIELDS (MOODY'S)

PRICES (END OF MONTH)

DECEMBER 1986	DECEMBER 1985	% CHAN. Y-T-D 1986-1985
1896.95	1546.67	22.58%
242.17	211.28	14.62%
138.56	121.56	13.98%
263.27	246.13	6.96%
225.62	214.86	5.01%
348.83	324.93	7.36%

DOW JONES INDUSTRIALS
STANDARD & POOR'S 500
NYSE COMPOSITE
AMEX MARKET VALUE INDEX
VALUE LINE COMPOSITE
NASDAQ COMPOSITE

UNDERWRITING

	FULL YEAR 1986	FULL YEAR 1985	% Change 1986-1985
CORPORATE FINANCING (Gross New Issues - \$ Mills)			
TOTAL	\$285,331.8	\$138,287.9	106.3%
Common Stock			
# of Common Stock Issues	\$43,047.0	\$24,727.4	74.1%
	1,197	745	60.7%
Preferred Stock			
# of Preferred Stock Issues	\$13,982.8	\$8,632.5	62.0%
	187	131	42.7%
Corporate Debt			
# of Corporate Debt Issues	\$228,302.0	\$104,928.0	117.6%
	2,383	1,346	77.0%
MUNICIPAL FINANCING (Gross New Issues - \$ Mills)			
Negotiated			
# of Issues	\$110,815.2	\$172,138.0	-35.6%
	3,072	4,264	-28.0%
Competitive			
# of Issues	\$32,756.0	\$27,142.2	-20.7%
	3,430	1,002	-242.3%

Source: IDD Information Services

RECENT INTERESTING READING AND STATISTICAL MATERIAL

<u>Item</u>	<u>Description</u>	<u>Source</u>
<u>Securities Industry Data Guide</u>	Directory of sources of securities industry data in seven major areas: Employee earnings; firm listings; firm rankings; general market information; mutual funds; securities industry profitability, and underwritings. Listings show description of data, cost name, address and phone of the data source.	SIA Publications Department \$5 each
<u>Annual Report - Federal Reserve Bank of New York</u>	In a departure from its traditional style, this year's report presents President Corrigan's essay outlining a future structure for the financial markets. Although a very broad-brush approach is applied, the financial structure envisioned is radically different than the current one. Inherent in the new model is the elimination of many legislative barriers between financial intermediaries, including the Glass-Steagall Act, and an extension of Fed supervisory power.	Federal Reserve Bank of New York 33 Liberty Street New York, NY 10045
<u>"Regionals Blast Majors With Growth"</u>	Annual rankings, 1986 vs. 1985, of Regional securities firms for their corporate underwriting activities. Top 15 lead managers are shown for categories: all issues; debt; common stock, and IPOs. Also, rankings are broken down by geographic regions such as Northeast and South Central.	Investment Dealers Digest 1/26/87

Economic Report of the
President

U.S. Government Printing
Office
Washington, D.C. 20402

Annual report reviewing economic developments that shaped 1986. Main topics of the seven-chapter report include budget control and tax reform, competitiveness and the trade deficit, and opening of international markets. Extensive historical statistics section, with most data series extending back to inception.

"Riding the Wild Bull"

Barron's
2/16/87

Barron's/Lipper gauge of fourth-quarter 1986 performance of mutual funds, along with articles on option funds, closed-end funds and how to figure taxes on fund shares.

Financial Innovations
Made to Measure

Euromoney Supplement
January 1987

Series of articles, written with an international slant, reviewing new financial products and their success, or lack of it, with investors. Of the numerous financial innovations in 1986, it is estimated that 85% were driven by special interest from Japan, particularly insurance companies.

"Top 1,000 Pension Funds"

Pensions & Investment Age
1/26/87

Employee benefit assets of the nation's 1,000 largest pension funds grew almost 25% to \$1.3 trillion during the year ended 9/30/86. The growth rate was on par with the previous year and attributed largely to investment returns. Article ranks 1,000 funds by asset size and presents profiles, including key personnel, for the 200 largest.

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AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY

Produced by the SIA Research Department

Vol. XIII, No. 2

March 30, 1987

A TALE OF TWO INDUSTRIES

It was the best of times. It was the worst of times. The securities industry had its best year ever in 1986 if performance is measured by many of the new record highs which were set. Commissions, trading gains, underwriting, mutual funds, total revenues and profits were but some of the parameters hitting new annual records. The year was also the worst of times when a relatively small number of individuals, with severe deficiencies in distinguishing right from wrong, scared the "Dickens" out of Wall Street, badly tarnishing the industry's image when they violated the public trust. Though not the worst of times, 1986's results, despite the records, also flagged warnings in areas such as mounting cost bases and deteriorating margins.

HIGHLIGHTS

1. In 1986, the securities industry earned a record pre-tax profit of \$5.5 billion, up 33.1% over 1985's then record \$4.1 billion.
2. Industry revenues last year jumped 29.7% to a record \$50.1 billion. Expenses, however, rose almost as much, 29.3%, to \$44.6 billion, also a record level.
3. Last year's 11.0% pre-tax profit margin, while slightly better than 1985's 10.7%, was mediocre for the Eighties - three years were better, three were worse.
4. Pre-tax ROE of 28.6% last year was the second lowest of the Eighties - only the 13.3% registered in 1984 was worse.
5. In this issue of Trends, SIA has for the first time attempted to estimate the components of "other revenue related to the securities business." Last year, the estimates showed 21% derived from private placement fees and 23% from M&A. We welcome comments from our readers regarding these estimates and the methodology used.

TABLE OF CONTENTS

<u>FEATURE</u>	<u>PAGE</u>
A Tale of Two Industries.....	1
Highlights.....	1
Table of Contents.....	2
Just for the Record.....	4
Mutual Funds.....	5
Fee Income.....	7
Underwriting.....	7
Commissions.....	10
Trading.....	13
Investment Gains.....	14
Other Securities Related Revenue.....	15
Interest.....	18
Expenses.....	19
Interest Expense.....	20
Other Expenses.....	20
Quarterly Performance.....	21
Balance Sheet Analysis.....	23
Addendum.....	25

TABLES

1. Statement of Income, 1985 vs. 1986.....	3
2. Total Industry Annual Performance.....	4
3. Mutual Funds.....	6
4. Bond Underwritings, Corporate vs. Municipal.....	7
5. Bond Underwritings, Amount vs. Revenues.....	8
6. Equity Underwritings.....	9
7. Commissions' Share of Revenues.....	10
8. Listed Equities, Commissions vs. Amount Traded.....	11
9. Proportion of Share Activity by Sector.....	12
10. Tradings' Share of Revenues.....	13
11. Commissions vs. Trading.....	14
12. Mergers & Acquisitions.....	16
13. Private Placements.....	17
14. Other Securities Related Revenue.....	18
15. Median RR Production and Payout.....	19
16. Total Industry Quarterly Performance.....	21
17. Quarterly Income Statement.....	22
18. Annual Statement of Financial Condition.....	23
19. Performance Scoreboard.....	24
20. Quarterly Statement of Financial Condition.....	24
21. Concentration.....	25
22. Total Industry Defined.....	26

Table 1

STATEMENT OF INCOME
TOTAL SECURITIES INDUSTRY

(In \$ Millions)

<u>Revenues</u>	<u>1985</u>	<u>1986</u>	<u>% Change</u>
Commissions	8,238.4	10,472.6	27.1
Trading Profits	9,944.3	12,560.8	26.3
Investment Gains	1,089.2	1,143.3	5.0
Underwriting	4,250.3	5,938.6	39.7
Margin Interest	2,577.7	2,919.5	13.3
Mutual Fund Sales	1,642.8	2,801.1	70.5
Fees, Account Supervision	947.4	1,466.7	54.8
Research	17.8	45.6	156.2
Commodities	983.2	1,064.7	8.3
Other Securities Related	7,176.4	9,552.0	33.1
Other Unrelated	1,757.7	2,119.0	20.6
Total Revenues	38,621.2	50,082.4	29.7
<u>Expenses</u>			
RR Compensation	6,903.6	9,183.8	33.0
Clerical Compensation	6,218.5	8,423.2	35.5
Partner/Officer Comp.	1,119.9	1,358.0	21.3
Other Employee Comp.	331.3	439.7	32.7
Floor (Commission/Clearing)	1,310.3	1,697.8	29.6
Communications	1,921.8	2,288.1	19.1
Occupancy & Equipment	1,830.7	2,178.5	19.0
Promotional Costs	841.5	1,036.4	23.2
Interest Expense	10,127.6	12,425.4	22.7
Errors/Bad Debts	266.3	431.9	62.2
EDP	477.8	632.2	32.3
Non-Recurring Charges	98.9	70.7	(28.5)
Regulatory Fees	244.8	310.1	26.7
Other	2,797.4	4,096.2	46.4
Total Expenses	34,481.2	44,570.9	29.3
Pre-Tax Net Income	4,140.0	5,511.5	33.1

JUST FOR THE RECORD

Last year, we reported that the securities industry's profits and all major revenue lines rose substantially to record heights from the previous year. But that was relatively easy when comparing bull year 1985 to bear year 1984. This go-round it is a pleasure to report that 1986 repeated its predecessor year's climb in performance, which is all the more impressive since we're comparing a record year to another record year!

Table 1 graphically highlights the 30% gains in revenues and 33% gains in profits which catapulted these industry performance yardsticks to new records of \$50.1 billion and \$5.5 billion, respectively. As depicted, all revenue lines were up anywhere from 5% to 156%...all to record levels. Conversely, if we ignore non-recurring charges (a legitimate dismissal due to their nature), all expense categories were likewise, though unfortunately, rising also to new record totals.

Still, revenue gains outpaced rising costs which translated into a 33% gain in pre-tax profits to a record \$5.5 billion!

Before analyzing the details of last year's income statement, a quick look at these three main items (revenues, expenses, profits) during the Eighties gives some interesting background. Table 2 shows how both revenues and expenses have consistently increased from \$16 billion and \$14 billion, respectively, in 1980 to \$50 and \$45 billion last year. It also shows that in two of these seven years, 1981 and 1984, expense growth outpaced revenue gains resulting in declines in profitability. Finally, it shows that 1986, despite the record aggregate amounts achieved, was mediocre for the industry compared to the Eighties, with three years better and three years worse in profit margins, revenue growth, expense growth and profit growth. Obviously, as the securities industry keeps growing from what was essentially a cottage industry to a \$50 billion industry today, it becomes harder and harder to match the growth patterns of past bull market years.

Table 2

TOTAL INDUSTRY ANNUAL PERFORMANCE

<u>\$ Billions</u>	<u>80</u>	<u>81</u>	<u>82</u>	<u>83</u>	<u>84</u>	<u>85</u>	<u>86</u>
Revenues	16.0	19.8	23.2	29.6	31.2	38.6	50.1
Expenses	13.8	17.7	20.2	25.7	29.6	34.5	44.6
Profits	2.3	2.1	3.0	3.8	1.6	4.1	5.5
<u>% Change</u>							
Revenues	42.7	23.5	17.2	27.4	5.6	23.7	29.7
Expenses	35.9	28.2	14.3	27.6	15.0	16.5	29.3
Profits	105.7	(5.2)	41.5	26.0	(57.9)	157.5	33.1
Profit Margin (%)	14.1	10.8	13.1	12.9	5.2	10.7	11.0

Note: Annual percent changes and profit margins calculated on actual figures in millions of dollars.

MUTUAL FUNDS

Though growth becomes harder to achieve, some areas have turned in remarkable performances. Revenues from the sale of open-ended investment company shares last year were up 71%, by far the best year-to-year climb for any major revenue source (research jumped 156%, but at \$46 million is still less than 0.01% of all revenues...see table 1).

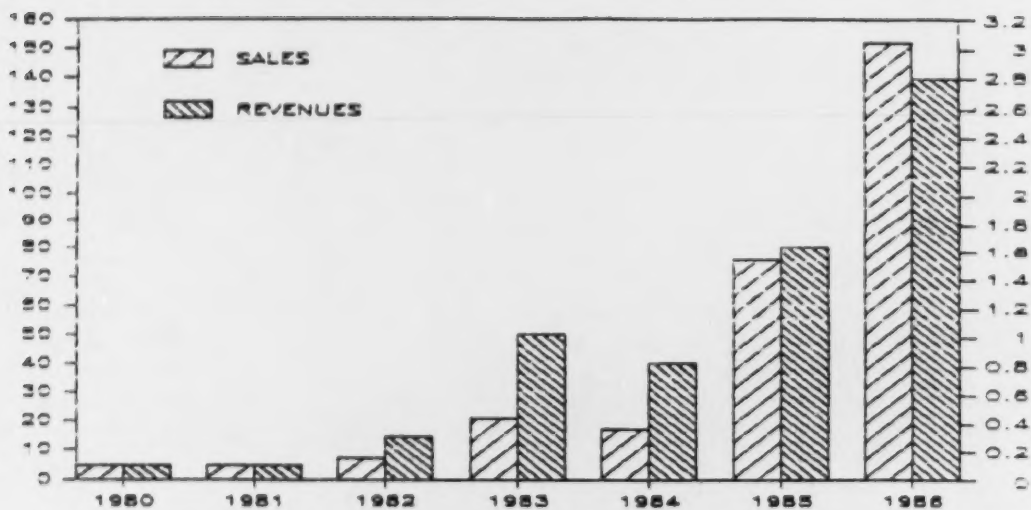
Closing at \$2.8 billion for 1986, mutual fund revenues have increased 27-fold from the \$105 million logged in 1980. Still, despite the phenomenal explosion in mutual funds' popularity, as this field also matures the growth and profitability trends also become harder and harder to maintain.

Table 3 maps the revenues from open-end mutual fund sales to the aggregate amount of new sales of equity and balance oriented mutual funds as compiled by the Investment Company Institute (ICI). As is shown in the table and graphically depicted in the chart beneath, the amount of revenues in relationship to the amount of sales kept increasing (margins kept getting better) through 1984 and then began declining (though totals kept increasing). Roughly speaking (using the ICI's sales figures vs industry revenues), the industry went from \$43 dollars worth of mutual fund sales in 1980 to just \$22 in 1983 and 1984 to produce \$1 in revenues. Subsequently, the dollar amount of mutual fund sales needed to keep generating that \$1 in revenues has shot up to \$46 in 1985 to \$54 last year. As the product life cycle matures, the inevitable margin erosion occurs...volume has skyrocketed and the resultant fierce competition has driven down the margin on revenues.

Table 3
MUTUAL FUNDS

Sales
(\$ Bils)

Revenues
(\$ Bils)



	<u>New Sales*</u> (\$ Bils)	<u>Revenues</u> (\$ Mils)	<u>Sales/Revenues</u> (Ratio)
1980	\$4.5	\$104.7	43 X
1891	4.6	122.0	38
1982	6.8	287.5	24
1983	20.8	952.1	22
1984	16.5	750.9	22
1985	76.3	1,642.8	46
1986	152.1	2,801.1	54

* New Sales are for equity and balance oriented mutual funds
compiled by the Investment Company Institute

FEE INCOME

Fee income, from account advisory and supervision, increased 55% last year, breaking the billion dollar mark for the first time, to a record \$1.5 billion. Since 43% of this amount was produced from the 10 National Full Line firms, the "financial consultant" type approach being emphasized by many of these firms seems to be producing some results.

UNDERWRITING

Underwriting revenues also made a dramatic 40% leap above last year's record level to a new \$6 billion record. The mix of corporate/municipal debt financings, however, did a complete flip-flop, with corporates more than doubling to \$228 billion underwritten while munis fell from \$243 billion underwritten in 1985 to \$161 billion, due to tax changes and other restrictions. In fact, it was the first time in the Eighties where corporate debt underwritings outpaced munis, and they did so with a vengeance (see Table 4). Still, even with the corporate onslaught last year, corporate bonds (at least the U.S. domestic portion) have yet to outpace 1985's \$243 billion publicly offered municipal bonds (although equities drive the corporate total up to \$285 billion).

Table 4

DOMESTIC DEBT UNDERWRITINGS

	<u>Corporate</u> <u>(\$ Bils)</u>	<u>Municipal</u> <u>(\$ Bils)</u>
1980	\$41.3	\$48.4
1981	40.5	47.7
1982	43.9	78.3
1983	52.2	85.7
1984	69.4	128.8
1985	104.9	243.3
1986	228.4	161.2

Source: IDD Information Services

However, since revenues from bond underwritings are not currently available by sub-categories, such as corporates, munis, or any other breakdown, we must look at all domestic bond underwritings vs. all bond underwriting revenues. As Table 5 shows, the amount of bonds underwritten needed to generate \$1 in revenues fell from \$97 in 1980 to \$49 in 1983. However, a thinning of spreads began to occur and this was largely laid at the door of Rule 415's advent, which

accelerated the trend towards stiffer competition, smaller, if non-existent syndicates, one/two-handed accounts, and an explosion in thin margin financings such as CMOs.

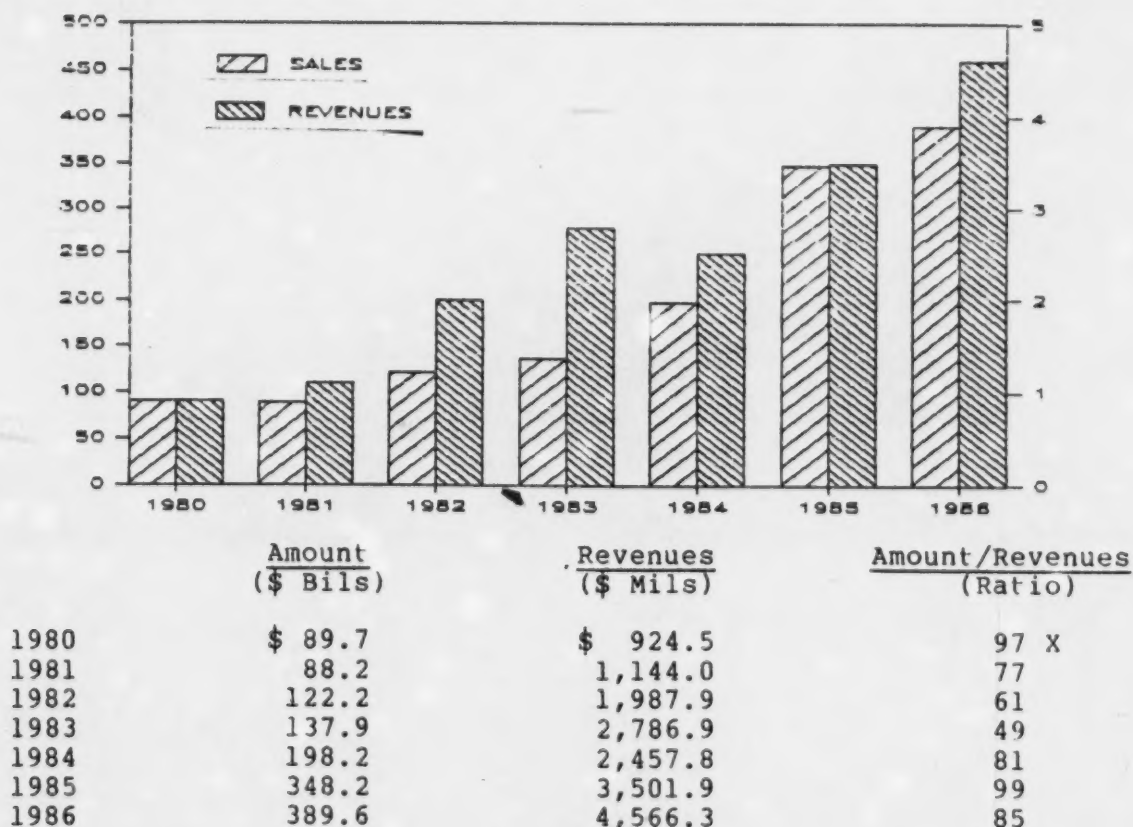
The heartening news for corporate and muni syndicate managers is that the trend reversed last year. It fell back to \$85 worth of bonds needed to raise \$1 in bond underwriting revenues. The second best ever year for munis and the record year for high-yield (and thus high-spread) corporates, no doubt helped. Disheartening is that beyond about a half dozen firms, controlling about two-thirds of all bond underwritings, only a handful of firms capture even 1% of the dollar amount of bonds underwritten.

Table 5

ALL DOMESTIC BOND UNDERWRITINGS

Sales
(\$ Bils)

Revenues
(\$ Bils)



Source: Securities Industry Database, IDD Information Services

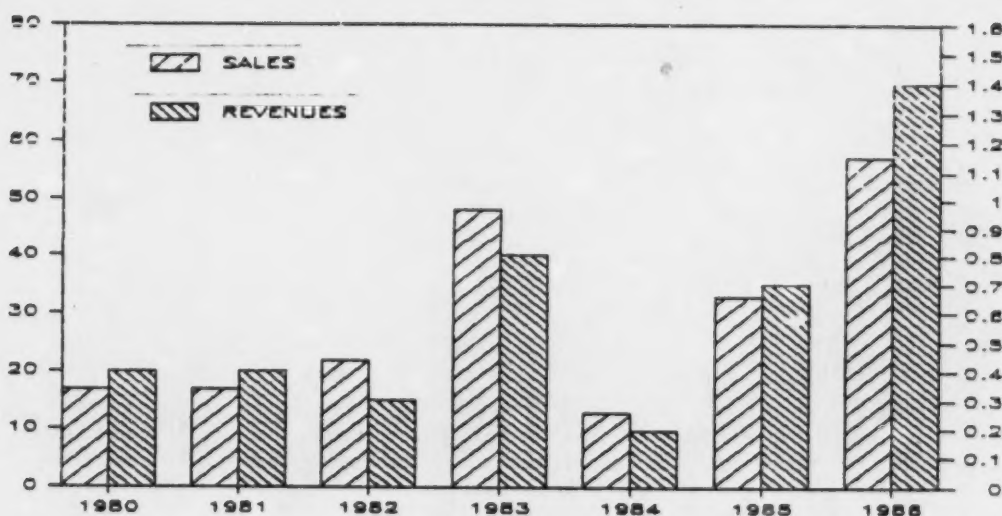
For corporate equities, where concentration is slightly less than on the bond front, Table 6 shows how the amount of equities needed to bring in that \$1 in revenues has steadily improved since 1983's bull market (although aggregate underwritings and revenues were best in bull years 1983 and 1986 - heavily due to initial public offerings).

Table 6

CORPORATE EQUITY UNDERWRITINGS

Sales
(\$ Bils)

Revenues
(\$ Bils)



	Amount (\$ Bils)	Revenues (\$ Mils)	Amount/Revenues (Ratio)
1980	\$16.6	\$403.3	41 X
1981	16.7	424.1	39
1982	21.7	328.2	66
1983	47.8	754.5	63
1984	12.9	248.3	52
1985	33.3	748.4	44
1986	57.0	1,372.3	42

Source: Securities Industry Database, IDD Information Services

COMMISSIONS

Commission revenues climbed 27% to a record \$10.5 billion, or 21% of total revenues. This was second only to trading profits, \$12.6 billion, or 25% of total revenues. Despite the record amount of dollars raised via commissions, Table 7 shows how 1986 continued the trend towards the overall industry's declining dependence on commissions as yesteryear's primary revenue source.

Table 7

COMMISSIONS' SHARE OF TOTAL REVENUES

1973	55.48
1974	49.1
1975	49.9
1976	45.8
1977	41.7
1978	42.8
1979	35.8
1980	35.4
1981	27.0
1982	25.9
1983	28.2
1984	22.7
1985	21.3
1986	20.9

Not only are total commission revenues declining in importance relative to total revenues, but if you compare commission revenues from listed equities executed on an exchange (the bulk of all commissions, 72% of total commissions last year) to the value of those equities crossed, there's been a dramatic erosion in commission dollars relative to the value of those shares.

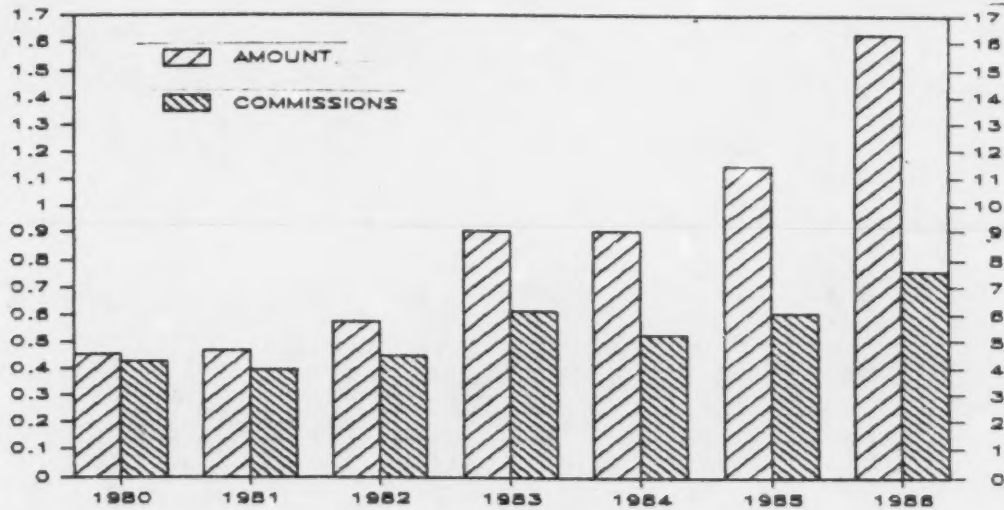
Table 8 illustrates how much larger amounts of equity business must now be transacted in order to generate the same commission dollar of previous years. Back in 1980, the value of shares traded on the NYSE, AMEX and Regional Exchanges, \$453 billion, was 107 times the \$4 billion in commission revenues from equities traded on those markets. This steadily eroded and last year it took twice the amount of equity volume as in 1980 to generate the same commission dollar: the \$1.6 trillion worth of equities traded was 216 times the \$7.6 billion in revenues from listed equities.

Table 8

LISTED EQUITIES - COMMISSIONS VS. AMOUNT TRADED

Amount
(\$ Trils)

Commissions
(\$ Bils)



	Amount (\$ Bils)	Commissions (\$ Mils)	Amount/Commissions (Ratio)
1980	453.3	4,237.5	107 X
1981	464.2	3,954.7	117
1982	575.3	4,484.1	128
1983	903.8	6,131.5	147
1984	901.2	5,232.6	172
1985	1,147.4	6,069.8	189
1986	1,630.7	7,561.9	216

In other words, while the value of listed equity business has grown 3.6 fold since 1980, commissions from that business grew at half that rate...1.8 fold!

Quite often, this erosion is laid at the doorstep of increased institutional dominance of the equities business. In the past this growth in institutional participation was "proved" using proxies for institutional/retail activity such as block volume. Beginning in early 1985, SIA has been able to track the actual total activity of the retail, institutional and member trading proportion of volume on the NYSE and AMEX (and professional institutional share of activity on NASDAQ). Unfortunately, this does not yet allow for much of a historical comparison, but if "institutionalization" is the culprit in the lag of commission growth relative to total listed equity business, the figures for 1985 vs. 1986 certainly don't support this claim.

Table 9 clearly shows that professional institutions' share of total share activity on the NYSE, AMEX and OTC marts declined from their 1985 levels last year (though aggregate activity was up for all categories). Both the retail and member trading share of last year's activity were up. Therefore, at least for 1985 vs 1986, part of the answer lies in changes in overall, including retail, commission rates, ever increasing RR payout structures applied (for payout effects see Table 15) and industry-wide discounting now being a fact of life.

Table 9

**PROPORTION OF SHARE ACTIVITY
BY SECTOR**

	NYSE		AMEX		OTC	
	Proportion of Share Activity <u>1986</u>	<u>1985</u>	Proportion of Share Activity <u>1986</u>	<u>1985</u>	Proportion of Share Activity <u>1986</u>	<u>1985</u>
Professional Institutions	42.3%	45.3%	25.6%	28.4%	19.3%	21.4%
Retail Sector	29.9	28.9	54.0	51.9	N/A	N/A
Member Firm Trading	27.8	25.8	20.4	19.7	N/A	N/A

* 1985 data only May to December 1985

Source: SIA, Investor Activity Report

TRADING

As previously mentioned, trading gains were again the number one revenue source for the securities industry last year accounting for one quarter of all revenues. Hitting a record \$12.6 billion, this now premier revenue generator increased 26% over last year's record \$10 billion amount. As was the case with commissions, however, the year-to-year increase slightly lagged overall revenue increases of 30%. That slight lag left 1985 as the record year for trading's largest percentage contributor to total revenues (although only marginally more than in 1986) but trading's growing, if not dominant, importance is illustrated in Table 10.

Table 10

TRADING'S SHARE OF TOTAL REVENUES

1973	8.4
1974	12.8
1975	15.6
1976	17.5
1977	15.7
1978	14.8
1979	19.2
1980	19.6
1981	21.4
1982	25.6
1983	23.1
1984	24.2
1985	25.7
1986	25.1

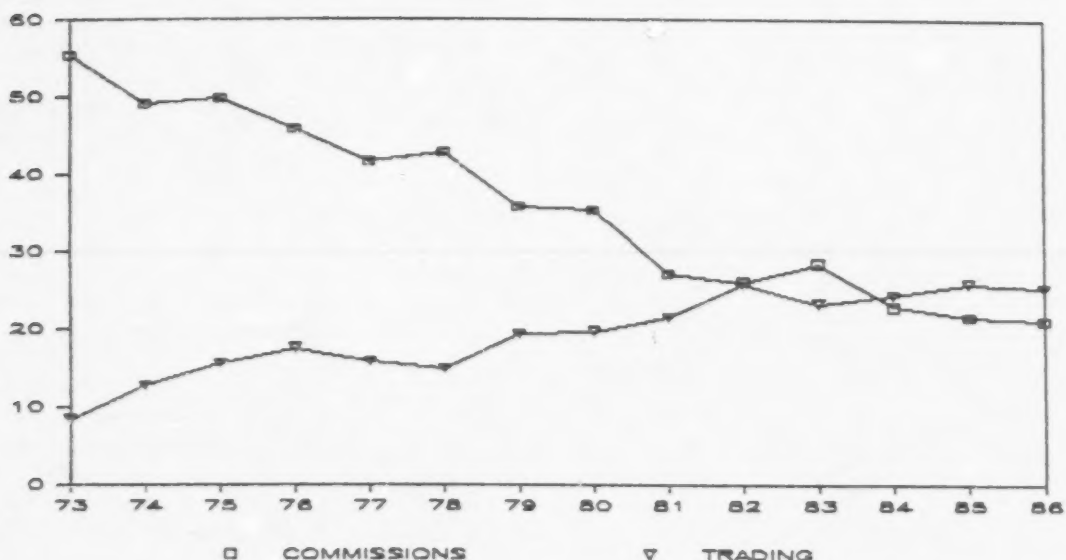
Note: 1973-75 includes trading as well as investment gains.

Tradings' growing importance mirrors commissions' declining share, that is your left appears as your right. Table 11 shows the percent of total revenues each business contributed since 1973 and commissions' once major role converges with tradings' once minor role until the Eighties when they are now diverging in favor of tradings' new dominance.

Table 11

COMMISSIONS VS. TRADING REVENUES

Percent of
Total Revenues



INVESTMENT GAINS

If any area of the securities business last year epitomized "the best of times vs. the worst of times," it was in gains and losses from firms' own investment accounts. For the year, the \$1.1 billion net gain from this area was up a mere 5% over 1985, although that was still a record amount. The bad news was that at mid-year, the amount stood at \$1.2 billion before turning downhill.

The third quarter's mere \$174 million gain was more than wiped out with \$201 million in the loss column for the final quarter, resulting in 1986 closing at lower than its mid-year level. Not coincidentally, this was the quarter when some major firms took major hits on their investments subsequent to Ivan Boesky's pre-announcement, and SEC-sanctioned, selloff. At any rate, the quarter-to-quarter volatility last year in investment gains/losses, should be sending up a few warning flags to those firms targeting as a major profit source areas such as taking positions in their own deals, bridge financings, LBOs, mezzanine financings, etc., to the risk side of the risk/reward ratio. As Goldman, Sachs partner James P. Gorter said at SIA's Trends Conference this January: "When

you're putting up billions of dollars in credit or billions of dollars in bridge financing or when you're standing behind transactions of that size, you're taking inordinate risks, and I'm not sure any reward is worth that risk."

OTHER SECURITIES RELATED REVENUE

With the current limitations of the FOCUS Report's income statement format and instructions, differences in line reporting by carrying and non-carrying firms, and resultant variations in interpretation and reporting, analyzing the line "other revenues related to the securities business" is, at best, a difficult chore.

First, non-carrying firms filing FOCUS Part IIA, are instructed to place their M&A and private placement revenues under underwriting revenues. Nevertheless, these firms constitute only about 2% of all revenues. Carrying firms are told to place private placement, proxy solicitation fees, service charges, option fees conducted away from an exchange, etc., in other securities related revenue.

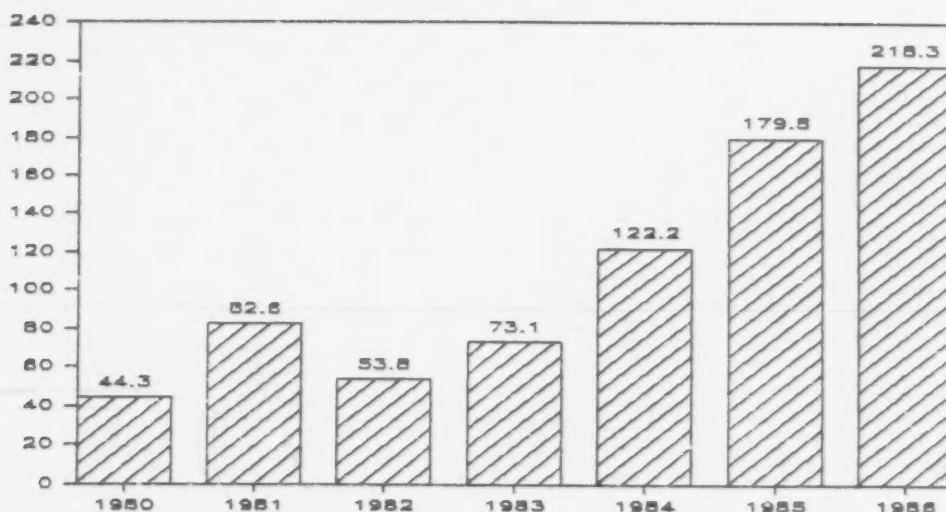
Since this revenue line constitutes about 20% of total revenues and nearly \$10 billion last year, it deserves some analysis, although lack of data presents obvious limits. It has been SIA's judgement that the bulk of the revenues reported here are attributable to M&A activity, private placement fees and dealings in repos and reverse repos, although their total or individual share is unknown. But since data is now available on two of these three markets, M&A and private placements, it is of some use to look at these markets when observing "other securities related" and its 33% gain last year to nearly \$10 billion.

First, the 10 Large Investment Banks reported \$3.9 billion and the 10 National Full Line Firms reported \$3.7 billion, or together about 80% of the total. These same firms are found in the top rankings for M&A and private placement financings. However, it must be remembered that these two fields are open to non-securities firms and some large commercial banks also appear side by side with securities firms in the top rankings. So, fees from these two investment banking functions are not totally funneled into the securities industry.

Table 12

MERGERS & ACQUISITIONS

Purchase Price
(\$ Bils)



Sources: 1980-85 data, W.T. Grimm & Co. for publicly announced deals of \$500,000 or more (purchase 10% or greater interest). 1986 data, IDD Information Services, for publicly announced deals of \$1 million or more (including repurchases, self-tenders and recapitalizations of 50% or more).

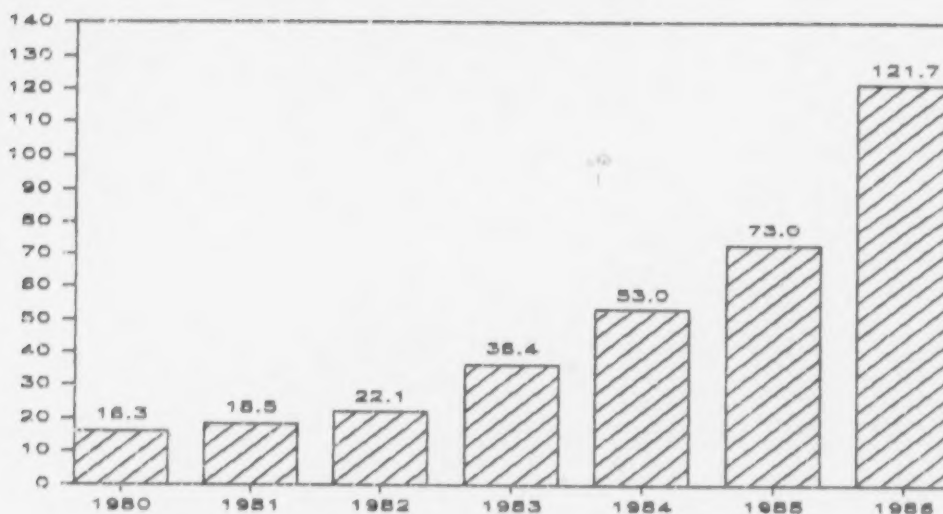
Since 1980, the dollar value of M&A activity has increased five-fold from \$44 billion to \$218 billion (Table 12). Not surprisingly, all but one of the top 10 advisors for both acquiror and target companies last year were National Full Line Firms and Large Investment Banks, according to rankings provided by IDD Information Services (the other being a non-NYSE firm, Kohlberg Kravis Roberts).

Using IDD's figures for deals of \$1 billion or more where fees were announced, we come up with a weighted average of 1.01% as the total fees vs. the purchase price paid by both the acquiror and target companies. Using that weighted average vs. the \$218.3 billion in M&A purchase prices paid last year gives an estimate of \$2.2 billion in M&A fees last year. Assuming the bulk of that was paid to NYSE member firms, we estimate about 23% of the \$9.6 billion "other related" revenues last year came from M&A fees.

Table 13

PRIVATE PLACEMENTS

Amount
(\$ Bils)



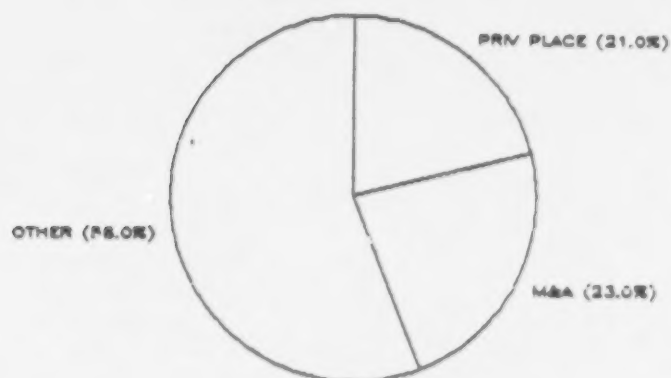
Source: Investment Dealers' Digest/IDD Information Services

While M&A has experienced a five-fold increase from 1980 through 1986, domestic private placements nearly doubled that growth with a nine-fold increase going from \$16 billion to \$122 billion (Table 13). In this area, commercial banks have a much bigger foothold. According to IDD's rankings, last year six of the top 20 agents (based on equal credit to each agent) were commercial banks with a combined market share of 18.6% of the \$122 billion placed. Since these top 20 have a combined 98% market share, these 20 are effectively the industry and thus the securities industry handled roughly 80% of all private placements last year.

Unfortunately, due to their nature, data on fees from private placements are difficult to ascertain. Using last year's average gross spread on publicly offered corporate bonds of 2.04% against all private placed debt and equity-related issues gives a reasonable estimate of the fees generated in this arena. This gives a total of \$2.5 billion in private placement fees, \$2 billion (80%) of which would have flowed to the securities industry. That translates into another 21% of "other securities related" revenues for a total of 44% of this revenue line contributed from both M&A and private placements (Table 14).

Table 14

SOURCES OF "OTHER SECURITIES RELATED" REVENUE



INTEREST

Margin interest increased only 13% from 1985 to 1986, about half the rate of increase in commissions, 27%, and interest expenses, 23% (see Table 1). During the year, margin interest revenues were pretty steady with quarterly results of \$703, \$745, \$722 and \$750 billion, respectively, reported during each of the quarters (see Table XX). Though rates charged on margin accounts steadily declined about 200 basis during the year, it would not be unfair to have expected better overall margin interest results considering margin debt balances (for our NYSE member group) during the year showed a 37% linear increase from January's \$27 billion outstanding to December's \$37 billion, a much higher relative increase compared to the interest rate decline.

In comparison, the previous year, 1985, when there was only a 100 basis point dropoff in rates, margin interest revenues steadily increased from \$585 million in Q1 to \$709 million in Q4, while margin debt balances increased steadily from \$22 billion in January to \$28 billion in December.

Here, again, FOCUS reports are limited in the analysis which can be applied to interest income, expense and profits. Although margin interest is broken out on the revenue side of the income statement, total interest revenue is not (e.g. interest and dividends are netted against trading revenues). On the other hand, on the expense side of the income statement, total interest expense is reported.

To arrive at some estimate as to how the industry fares on a net interest income level, we examined the financial reporting of the publicly held brokerage firms. For both the major publicly held National Full Line and large Investment Bank brokerages, as well as all the publicly held brokerages, 1986 showed a median 5% net interest income to net revenues. Projecting this to our industry figures shows total gross interest income of approximately \$14.3 billion last year, or 27% of total revenues. Since the industry showed total interest expense of \$12.4 billion last year, that leaves \$1.9 billion as net interest income for 1986.

EXPENSES

Compensation, the industry's ever present largest expense, 44% of all expenses last year, up from 42% in 1985, continues to be the single most important cost which haunts the securities industry's profit margins. Also, the biggest siphon of dollars in the compensation area, is RR compensation. Last year, RR comp. increased 33% over 1985's \$6.9 billion to a record \$9.2 billion. That outpaced both commissions' 27% year-to-year increase and overall revenues' 30% gain!

Table 15 illustrates how there is an overall "inelasticity of demand" in the industry's payout structure on both the retail and institutional sales level.

Table 15

MEDIAN RR PRODUCTION AND PAYOUT

(\$ Thousands)

	<u>Production</u>				
	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
Retail	106	114	139	121	136
Institutional	307	422	570	370	424

	<u>Payout</u>				
	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
Retail	41	41	42	43	43
Institutional	32	28	29	29	31

Source: Report on Production and Earnings of RRs in 1985, SIA

Despite dropoffs in median gross production of both institutional and retail RRs in 1985 and 1984 from their 1983 levels (1986 data not yet available), payout ratios were still increased. Naturally, the competition for productive RRs is extremely intense since they are the backbone of industry profitability. This makes it extremely difficult for firms to alter downward their payouts because of the very justified fear that this will cause both an exodus of their best producers and a strong deterrent in attracting new talent.

Nevertheless, this predominant of all competitive pressures remains the number one margin destroyer of the securities industry and always wreaks havoc on the income statement whenever the bear stirs from hibernation. Whenever any firm does attempt to rejigger its payout structures in its own favor, it usually does suffer the exodus/competitive disadvantage consequences. Will there ever occur an industrywide concerted effort to radically alter the payout structure? Though it's often called for, collusion would be illegal and competitive pressures have proven that to unilaterally attempt the change can be suicidal. Nevertheless, some progress was made at some firms last year in realigning payouts on some product lines, e.g. high margin, in-house mutual funds, etc., and on lower producing earners.

Back-office personnel costs last year actually showed a bigger increase than RR comp. Up 36% from 1985 to a record \$8.4 billion, this cost is equally eating away at revenue income...22% of all 1986 revenues.

INTEREST EXPENSE

If compensation is looked at by its different components and not just one large cost item, then interest expense is the biggest ticket on the expense sheet. Last year's \$12.4 billion interest expense was 28% of all expenses. Still, as shown earlier, net interest was estimated to be in the plus column at \$1.9 billion for 1986.

Overall, interest expense increased 23% for 1986 vs. 1985. That was a lot slower increase than the 30% gain in revenues. Quarterly, interest costs hovered at around \$3 billion (see Table 20). Though interest rates dropped around 200 basis points over these four quarters, the steady interest cost over the period was not bad considering liabilities rose \$5 billion during the same period.

OTHER EXPENSES

Error and bad debt expenses jumped 62% to \$432 million last year or 0.9% of total revenues. For the previous five years, errors accounted for a slightly lower 0.7% to 0.8% of revenues. Although these amounts look relatively small when compared to other expenses ranging in the billions, industry worries over the burdens of handling ever record breaking amounts of orders do appear to be taking more of a toll on the error cost column.

Communications, occupancy, equipment, promotional and regulatory fee expenses all increased at much slower rates than revenue's 30% gains in 1986. Non-recurring charges even showed a 29% drop from 1985's level. If there had been bigger increases in almost any of these items, overall expenses could have outstripped revenue's 30% gain.

QUARTERLY PERFORMANCE

Table 17 shows last year's first quarter revenues hit a record \$12.91 billion and then fell off until the last quarter which broke that record with \$12.96 billion in revenues. Profits followed a similar pattern, but with one major exception. In the first quarter, pre-tax profits hit a quarterly record \$1.95 billion. As with revenues, profits declined for the next two periods and bounced back in the last quarter.

The major exception was that profits didn't bounce back to a new quarterly record as did revenues. Expenses, again, keep increasing faster than revenues. As Table 16 shows, pre-tax profit margins last year fell from a high of 15.1% in the first quarter to 9.0% in the last quarter. For the past two years, only 1985's third quarter margin of 8.0% was lower than the margin in Q4 1986.

Table 16

TOTAL INDUSTRY QUARTERLY PERFORMANCE

<u>\$ Billions</u>	<u>85.1</u>	<u>85.2</u>	<u>85.3</u>	<u>85.4</u>	<u>86.1</u>	<u>86.2</u>	<u>86.3</u>	<u>86.4</u>
Revenues	8.9	9.2	8.8	11.6	12.9	12.5	11.8	13.0
Expenses	8.0	8.2	8.1	10.1	11.0	11.1	10.7	11.8
Profits	0.9	1.0	0.7	1.5	1.9	1.3	1.1	1.2
<u>% Change</u>								
Revenues	5.2	3.2	(4.3)	31.2	11.3	(3.4)	(5.7)	10.3
Expenses	0.1	2.4	(0.9)	24.5	8.3	1.6	(4.0)	10.4
Profits	86.4	9.7	(31.0)	108.4	32.2	(31.8)	(20.0)	9.5
Profit Mgn (%)	10.4	11.1	8.0	12.7	15.1	10.7	9.1	9.0

Note: Quarterly percent changes and profit margins calculated on actual figures in millions of dollars.

Table 17

STATEMENT OF INCOME
TOTAL SECURITIES INDUSTRY

(In \$ Millions)

<u>Revenues</u>	<u>86:Q1</u>	<u>86:Q2</u>	<u>86:Q3</u>	<u>86:Q4</u>
Commissions	2,765.8	2,702.2	2,527.0	2,477.6
Trading Profits	3,962.1	2,808.6	2,815.3	2,974.8
Investment Gains	597.0	572.9	174.0	(200.6)
Underwriting	1,147.0	1,532.3	1,456.8	1,802.5
Margin Interest	702.8	745.4	721.7	749.6
Mutual Fund Sales	636.0	706.6	707.3	751.2
Fees	272.6	343.7	344.4	506.0
Research	4.8	10.1	22.2	8.5
Commodities	167.4	252.6	261.1	383.6
Other Related	2,150.7	2,263.5	2,242.6	2,895.2
Other Unrelated	501.6	525.0	479.3	611.1
Total Revenues	12,908.0	12,462.7	11,751.6	12,960.1
<u>Expenses</u>				
RR Compensation	2,235.4	2,271.3	2,213.4	2,463.7
Clerical Compensation	2,074.2	2,091.6	2,099.7	2,157.7
Partner/Officer Comp.	356.0	339.9	288.9	373.3
Other Employee Comp.	99.2	129.6	108.8	102.1
Floor Expenses	413.6	425.7	422.8	435.7
Communications	534.9	573.3	561.3	618.6
Occupancy & Equipment	510.3	517.5	550.3	600.4
Promotional Costs	219.8	252.5	241.9	322.2
Interest Expense	3,143.9	3,195.9	2,959.1	3,126.5
Errors/Bad Debts	110.4	80.3	93.1	148.1
EDP	148.1	162.4	156.1	165.6
Non-Recurring Charges	5.4	44.2	5.1	16.0
Regulatory Fees	69.4	73.1	77.0	90.6
Other	1,038.4	975.0	909.3	1,173.3
Total Expenses	10,958.3	11,132.1	10,686.7	11,793.8
Pre-Tax Net Income	1,949.7	1,330.6	1,064.9	1,166.3

Table 18

TOTAL INDUSTRY ANNUAL FINANCIAL CONDITION

<u>\$ Billions</u>	<u>80</u>	<u>81</u>	<u>82</u>	<u>83</u>	<u>84</u>	<u>85</u>	<u>86</u>
Assets	102.3	121.6	172.4	215.2	276.0	393.8	451.8
Liabilities	96.9	114.9	163.5	203.4	263.2	377.2	430.4
Capital	6.7	8.1	10.7	14.2	16.7	21.9	29.8
Equity	5.4	6.7	9.0	11.8	12.8	16.7	21.4
<u>% Change</u>							
Assets	36.3	18.9	41.8	24.8	28.3	42.7	14.7
Liabilities	36.5	18.6	42.2	24.4	29.4	43.3	14.1
Capital	34.5	19.9	32.9	32.4	18.1	31.0	36.0
Equity	33.9	24.7	34.3	31.5	8.6	29.9	28.6
Pre-Tax ROE (%)	49.2	35.9	40.5	36.6	13.3	29.4	28.6
After-Tax ROE (%)	26.6	19.4	21.9	19.8	7.2	15.9	15.5

Note: Annual percent changes and ROEs calculated on actual figures in millions of dollars. After-tax ROEs assume a 46% corporate tax rate.

BALANCE SHEET ANALYSIS

As table 18 clearly shows, the industry's return on equity last year was the second lowest of the Eighties despite the record profits earned and three years in the Eighties with lower profit margins than 1986. Only in the poor 1984 was the industry's ROE at a lower level. If you look at the leveraging that has occurred in the Eighties, four out of the seven years, assets and liabilities were expanding at bigger rates than the industry's equity. Last year, the industry's equity base expanded 29% - double the 14% and 15% rate liabilities and assets grew. Even in years 1981 and 1983, when equity grew faster than assets and liabilities, it didn't come close to growing twice as fast as it did last year.

For many who have expressed very real concern that the securities industry is too highly leveraged, last year's bit of unleveraging will be of some comfort. However, this near \$5 billion of new equity, with a year-end close of over \$21 billion, was not utilized to the productive levels of previous years (as the previously discussed higher ROEs in the rest of the Eighties indicates) nor was it bringing in a return comparable to other measures of returns last year. As Table 19 clearly shows, even before taxes, the industry's 28.6% ROE underperformed areas such as the Dow, the S&P 500 or even the return on rare coins!

Table 19

1986 PERFORMANCE SCOREBOARD

(Annual Return in Percent)

Industry Pre-tax ROE	28.6
Dow Jones Industrial Average	33.6
S&P 500	31.6
Lipper Growth Fund Index	30.3
Lipper International Fund Index	48.2
Rare Ccins	32.0

Source: Wall Street Journal, January 2, 1987.

If the year's ROE was poor, it is even more so when you consider how much the first quarter helped from dropping off the board. For the second half of 1986, the industry was earning only 11% to 12% after taxes on its growing equity base.

Comparing last year to the beginning of the Eighties, the industry has increased its equity and capital base four-fold since 1980, but it only managed to increase its revenues three-fold and its profits two-and-one-half-fold.

Table 20

TOTAL INDUSTRY QUARTERLY FINANCIAL CONDITION

<u>\$ Billions</u>	<u>85.1</u>	<u>85.2</u>	<u>85.3</u>	<u>85.4</u>	<u>86.1</u>	<u>86.2</u>	<u>86.3</u>	<u>86.4</u>
Assets	254.7	282.4	298.7	393.8	400.0	417.0	431.1	451.8
Liabilities	241.7	268.6	284.4	377.2	381.7	397.6	410.6	430.4
Capital	16.8	17.8	18.7	21.9	24.7	26.0	28.0	29.8
Equity	12.9	13.7	14.3	16.7	18.3	19.4	20.5	21.4
<u>% Change</u>								
Assets	7.7	10.9	5.8	31.9	1.6	4.2	3.4	4.8
Liabilities	8.1	11.1	5.9	32.6	1.2	4.2	3.3	4.8
Capital	(0.5)	6.4	5.1	17.0	12.5	5.5	7.7	6.3
Equity	1.5	6.0	4.3	16.4	10.0	5.8	5.7	4.6
Pre-Tax ROE (%)	29.0	30.8	20.2	38.1	44.6	28.2	21.4	22.3
After-Tax ROE (%)	15.7	16.6	10.9	20.6	24.1	15.3	11.5	12.0

Note: Quarterly percent changes and ROE calculated on actual figures in millions of dollars. ROE annualized and after-tax ROE assumes a 46% corporate tax rate.

Table 21

SECURITIES INDUSTRY CONCENTRATION

<u>Total Revenues</u>	<u>80</u>	<u>81</u>	<u>82</u>	<u>83</u>	<u>84</u>	<u>85</u>	<u>86</u>
Top 10	53.1%	55.6%	57.3%	54.4%	58.8%	57.5%	57.3%
Top 11-25	19.4	18.7	18.7	19.6	17.1	19.7	19.8
Rest of Industry	27.5	25.7	24.0	26.0	24.1	22.8	22.9
	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
<u>Total Capital</u>							
Top 10	50.8%	50.0%	54.8%	52.8%	57.2%	63.2%	61.9%
Top 11-25	18.0	19.7	18.3	18.8	15.6	14.8	16.0
Rest of Industry	31.2	30.3	26.9	28.4	27.2	22.0	22.1
	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Based on capital, the biggest 10 securities firms gave up a little of their predominant share of both industry revenues and capital. Still, with the 10 largest capitalized firms (as of 12/31/86) controlling 57% of industry revenues and 62% of total capital, one would be hard pressed to say that the securities industry is becoming less concentrated. In fact, the 11 through 25 largest firms increased their share of industry revenues and capital a bit. On the revenue side, the rest of the industry made a minimal gain of 0.1% to be left with 22.9% of all revenues. On the capital side, the non-25 largest firms made the same 0.1% comeback to now hold 22.1% of all capital. That's a far shot from the 31.2% share they had back in 1980.

ADDENDUM

In our analysis of the securities industry, SIA relies on the the uniform reporting on the FOCUS form of New York Stock Exchange member firms which do a public business. These firms, though relatively few in number compared to all registered broker-dealers, account for the vast majority of the assets, capital, revenues, profits, etc., of the entire securities industry. It is for this reason, together with SIA's access to the NYSE group's quarterly financials, that this group is used as the proxy for the entire securities industry. Therefore, all references in this report to "total securities industry" refer to these NYSE reporting firms. The following tables give the reader the historical share of the NYSE firms doing a public business vs all broker-dealers listed as registered by the SEC. Data for 1986 for the SEC's "All Firms" is not yet available.

Table 22

NYSE GROUP'S SHARE OF TOTAL INDUSTRY*

<u>Item</u>	(Percent)						
	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
Revenues	80	80	81	81	80	81	77
Assets	84	85	78	86	85	88	86
Capital	66	65	66	70	72	71	70
Equity	63	63	65	69	71	69	68
<u># of Firms</u>							
NYSE Group	374	389	390	387	412	393	381
All Firms	4,824	5,283	5,714	6,165	7,429	8,298	8,763

* Total industry based on data appearing in the SEC Monthly Statistical Review, August 1986.

The first striking fact is that the number of all firms has almost doubled over the above time span while the NYSE group remains about the same. Still, though the NYSE group is now down to about 4% of all firms from 8% in 1979, they still maintain about 80% of all revenues and 85% of assets. It is the NYSE group which handles the "core" amount of securities business and, as was seen just previously in this report under concentration, the vast amount of the NYSE group's business is handled by the 10 or 25 largest firms.

VOLUME

	JAN 1987	JAN 1987	JAN 1986	JAN 1986	% CHAN. J-J 1987-1986
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	193.1	193.1	130.9	130.9	47.5%
AMEX (MILS.)*	14.8	14.8	11.1	11.1	33.3%
NASDAQ (MILS.)*	151.8	151.8	109.7	109.7	38.4%
REGIONAL EXCHANGE (MILS.)*	29.4	29.4	22.3	22.3	31.8%
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	\$163,620	\$163,620	\$105,010	\$105,010	55.8%
AMEX (MILS.)	4,935	4,935	2,746	2,746	79.7%
ODD-Lot SHARES PURCHASED ON NYSE (THOUS.)	11,321	11,321	8,269	8,269	36.9%
ODD-Lot SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	19,103	19,103	18,589	18,589	2.8%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	50.8%	50.8%	49.5%	49.5%	---
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	19,455	19,455	15,226	15,226	27.8%
AMEX OPTIONS	4,789	4,789	4,738	4,738	1.1%
COMMODITY	15,917	15,917	16,279	16,279	-2.2%

*MONTHLY AVERAGE

N/A - DATA NOT AVAILABLE

UNDERWRITING

	OCTOBER 1987	OCTOBER 1986	% Change 1987-1986
CORPORATE FINANCING (Gross New Issues - \$ Mil's)			
TOTAL	\$24,211.2	\$13,392.5	80.8%
Common Stock	\$2,339.2	\$645.0	262.7%
# of Common Stock Issues	41	9	355.6%
Preferred Stock	\$420.7	\$1,901.5	-77.9%
# of Preferred Stock Issues	9	42	-78.6%
Corporate Debt	\$21,450.9	\$10,846.1	97.8%
# of Corporate Debt Issues	207	114	81.6%
MUNICIPAL FINANCING (Gross New Issues - \$ Mil's)			
Negotiated	\$7,207.3	\$1,156.3	523.3%
# of Issues	147	23	539.1%
Competitive	\$812.4	\$1,196.3	-32.1%
# of Issues	48	55	-12.7%

YIELDS

(MONTHLY AVERAGES)

OCTOBER 1987	OCTOBER 1986	BASIS POINT CHG 1987-1986
6.61%	8.08%	(147)
8.35	10.05	(169)
9.72	11.44	(172)
0.86	0.98	(2)
6.61	8.08	(147)

BOND BUYER INDEX (20 BOND)

CORPORATE BOND YIELDS (MOODY'S)

Aaa CORPORATE

Baa CORPORATE

RATIO Aaa CORP'S. TO Baa CORP'S.

MUNICIPAL BOND YIELDS (MOODY'S)

PRICES (END OF MONTH)

JANUARY 1987	JANUARY 1986	% CHAN. Y-T-D 1987-1986
2158.04	1570.99	37.37%
274.08	211.78	29.42%
156.11	122.13	27.82%
300.47	243.87	23.21%
249.17	215.80	15.46%
392.06	335.77	16.76%

DOW JONES INDUSTRIALS
STANDARD & POOR'S 500
NYSE COMPOSITE
AMEX MARKET VALUE INDEX
VALUE LINE COMPOSITE
NASDAQ COMPOSITE

RECENT INTERESTING READING AND STATISTICAL MATERIAL

<u>Item</u>	<u>Description</u>	<u>Source</u>
"Opportunities in the 1990's"	Transcript of SIA's eighth annual Trends Conference. Senior industry executives addressed the future of the securities industry with topics ranging from perspectives about overall opportunities available to brokerage firms in the capital and retail markets to specific subjects such as globalization new products in the capital markets area, and firms taking principal positions in their own deals. In addition, market segmentation and asset gathering, and the outlook for traditional and packaged products was discussed.	SIA Research Department Price \$75
"Mergers & Acquisitions-- Special Report"	Newly compiled rankings of M&A deals effective in 1986 that were valued at more than \$1 million. Numbers reveal Goldman, First Boston, and Morgan Stanley snared two-thirds of 1986 M&As. Statistical data includes deals completed and announced by industry and top advisors to these industries.	Investment Dealers' Digest 3/9/87
"The 1987 Pension Olympics"	Annual survey which tallies net new clients that investment management organizations have garnered from over 700 private and public pension funds. The top of the ladder is dominated by bank subsidiaries offering indexing and semi-active products based on computer-driven programs. The winner is Wells Fargo Investment Advisors with a net gain of 18 accounts and an additional \$24.7 billion in assets.	Institutional Investor 2/87

Item	Description	Source
"General Eclectic"	A look at the reshaping of the nation's third-largest company, GE. For the past decade, GE's earnings growth has mirrored the growth of GNP. The company wants to do better. Thus, GE's strategy calls for emphasis on fast-growing sectors like high technology and finance. Author presents his own list of potential takeover targets.	<u>Forbes</u> 3/23/87
"Through the Customers' Eyes"	An interview with SIA Chairman John Bachmann of Edward D. Jones & Co. covering the problems facing the brokerage industry. Issues discussed include the erosion of Glass-Steagall, recent insider trading scandals, and intensifying competition within the industry.	<u>Registered Representative</u> 3/87
"Coping with Globally Integrated Financial Markets"	NY Fed President Corrigan reviews developments in international markets, with emphasis on the areas which give rise to a sense of unease from the central bank's perspective.	<u>Quarterly Review</u> Federal Reserve Bank of New York Winter 1986-87
"Say Goodbye to Your Broker"	Brief update on automating the financial planner. Nevertheless, article concludes that there's still comfort for the customer in having someone who knows his account at the other end of the phone. The "future" could be a long ways off.	<u>Financial World</u> 4/21/87



Trends

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AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
Produced by the SIA Research Department

Vol. XIII, No. 3

May 20, 1987

FIRM CATEGORIES GENERATE RECORD PROFITS

HIGHLIGHTS

1. The securities industry as well as all the major firm categories experienced healthy growth in both revenues and profits last year to new record levels.
2. The 10 Large Investment Banks were the only firm category to experience a decline in profit margins during 1986's bull market. Soaring expenses, particularly compensation, and fourth quarter losses on investments were the main culprits.
3. Although also hit with investment losses in the fourth quarter, the 10 National Full Line firms enjoyed a 62% increase in profits last year on 31% higher revenues.
4. Regional firms kept a strong handle on expenses last year which resulted in a 44% increase in profits bringing their profit margin back up to the industry-wide average for the first time in five years.
5. Although the securities industry has witnessed a six-fold increase in capital to \$30 billion over the past five years, with similar increases for the firm categories, the return on capital dipped slightly last year and is far behind the returns enjoyed by the industry as well as major firm categories during the early Eighties.
6. Retail investor demand during last year's bull market drove commission revenues up 80% for the NYSE Discounters while their pre-tax profits tripled.

CONTENTS

<u>Feature</u>	<u>Page</u>
Highlights.....	1
Contents.....	2
The Year in Review.....	4
National Full Line Firms.....	7
Large Investment Banks.....	12
Regional Firms.....	16
Discounters.....	19
New York City-Based Firms.....	21
Commission Introducing Firms.....	23
Capital Employment.....	24
Room For Improvement.....	25

<u>Table</u>	<u>Page</u>
1. Income Statement - Total Securities Industry.....	3
2. Pre-Tax Profit Margins.....	4
3. Pre-Tax Return on Equity.....	5
4. Income Statement - National Full Line Firms.....	6
5. National Full Line 1986 Quarterly Results.....	7
6. Employees.....	9
7. Share of Employees.....	10
8. Income Statement - Large Investment Banks.....	11
9. Large Investment Banks' Quarterly Investment Gains.....	14
10. Income Statement - Regional Firms.....	15
11. Regionals' Margin Interest Revenues.....	17
12. Income Statement - NYSE Discounters.....	18
13. Income Statement - New York City-Based Firms.....	20
14. Level of Leverage.....	21
15. Income Statement - Commission Introducing Firms.....	23
16. Pre-Tax Return on Capital.....	24
17. Analysis of 1986 Profits, Interest and Compensation.....	25
18. Income Statement Definitions from the FOCUS Report.....	26

Table 1

STATEMENT OF INCOME
TOTAL SECURITIES INDUSTRY

(In \$ Millions)

<u>Revenues</u>	<u>1985</u>	<u>1986</u>	<u>% Change</u>
Commissions	8,238.4	10,472.6	27.1
Trading Profits	9,944.3	12,560.8	26.3
Investment Gains	1,089.2	1,143.3	5.0
Underwriting	4,250.3	5,938.6	39.7
Margin Interest	2,577.7	2,919.5	13.3
Mutual Fund Sales	1,642.8	2,801.1	70.5
Fees, Account Supervision	947.4	1,466.7	54.8
Research	17.8	45.6	156.2
Commodities	983.2	1,064.7	8.3
Other Securities Related	7,176.4	9,552.0	33.1
Other Unrelated	1,757.7	2,119.0	20.6
Total Revenues	38,621.2	50,082.4	29.7
<u>Expenses</u>			
RR Compensation	6,903.6	9,183.8	33.0
Clerical Compensation	6,218.5	8,423.2	35.5
Partner/Officer Comp.	1,119.9	1,358.0	21.3
Other Employee Comp.	331.3	439.7	32.7
Floor (Commission/Clearing)	1,310.3	1,697.8	29.6
Communications	1,921.8	2,288.1	19.1
Occupancy & Equipment	1,830.7	2,178.5	19.0
Promotional Costs	841.5	1,036.4	23.2
Interest Expense	10,127.6	12,425.4	22.7
Errors/Bad Debts	266.3	431.9	62.2
EDP	477.8	632.2	32.3
Non-Recurring Charges	98.9	70.7	(28.5)
Regulatory Fees	244.8	310.1	26.7
Other	2,797.4	4,096.2	46.4
Total Expenses	34,481.2	44,570.9	29.3
Pre-Tax Net Income	4,140.0	5,511.5	33.1

THE YEAR IN REVIEW

As was seen in March's Trends and in Table 1, the securities "industry" (defined as all New York Stock Exchange member firms doing a public business which have historically accounted for about 80% of revenues and 85% of capital of all broker-dealers operating in the U.S.) earned a record \$5.5 billion of pre-tax profits, up 33.1% over 1985's then record \$4.1 billion. Industry revenues also hit a record \$50.1 billion last year, up 29.7% over 1985. Expense increases about matched that rise, jumping 29.3% to \$44.6 billion.

All major firm categories also showed year-to-year increases in revenues and profits to record heights (due to firm category reclassification during 1986, some categories, such as Commission Introducing and New York City-based regionals, can no longer be directly compared to years prior to 1986 for most data fields).

The 10 National Full Line firms (NFLs), while still the laggard in profit margins and returns on equity and capital, showed the best year-to-year profit increase (of categories still comparable) with a 61.7% increase in pre-tax net income to a record \$1.5 billion last year. This compares to only a 17% increase in profits for the 10 Large Investment Banks (LIBs). Regional firms, meanwhile, posted a healthy 44% gain in pre-tax net income.

These three major groups all achieved revenue increases of between 26% and 31% last year but as Table 2 illustrates, the LIBs' profit margin deteriorated while the others improved (although LIBs' margins are still relatively high).

Table 2

PRE-TAX PROFIT MARGINS

(In Percent)

<u>Firm Category</u>	<u>80</u>	<u>81</u>	<u>82</u>	<u>83</u>	<u>84</u>	<u>85</u>	<u>86</u>
National Full Line	10.9	6.9	8.8	8.6	(0.9)	5.6	6.9
Large Investment Banks	17.7	15.4	17.4	16.7	11.4	14.6	13.5
Regionals	14.7	11.2	11.1	12.6	2.6	9.4	11.0
New York City Based	14.8	12.6	14.0	18.3	8.9	12.3	16.1
NYSE Discounters	17.5	12.2	13.6	14.0	0.3	8.9	15.7
Commission Introducing	16.9	10.9	15.9	18.8	9.5	19.8	22.1
Total Industry	14.1	10.8	13.1	12.9	5.2	10.7	11.0

As seen, the NFLs improved their profit margin more than a full percentage point, enough to jack-up earnings 62%; but at 6.9% this group still has the lowest margins of all categories. The Regionals, which have turned in lower margins than the industry since 1982, matched the industry's 11.0% profit margin last year which, as with the NFLs, was the second consecutive year of improvement. On the other hand, the LIBs' 13.5% margin last year was a setback and was the second lowest percentage for this group during the Eighties with only 1984, when there was industry-wide poor performance, the only time when profit margins were lower for these 10 firms as a group.

Profit margins are one of data fields which should not be affected by last year's firm recategorization, and thus all categories are shown in Table 2. The three remaining firm categories all showed improved and healthy margins last year. Both the New York City-based regional firms (NYCs), a group which resembles characteristics of both Regionals and LIBs, and NYSE Discounters showed their second highest profit margins of the Eighties. Meanwhile, Commission Introducing firms (CIs), which neither carry customer accounts nor do any clearing and thus file a different, abbreviated FOCUS Report, achieved their highest margin of the Eighties and also, as they did in bull years 1983 and 1985, turned in the highest profit margin of all firm categories.

Table 3

PRE-TAX RETURN ON EQUITY

(In Percent)

<u>Firm Category</u>	<u>80</u>	<u>81</u>	<u>82</u>	<u>83</u>	<u>84</u>	<u>85</u>	<u>86</u>
National Full Line	45.0	24.6	29.8	28.1	(2.6)	17.9	20.3
Large Investment Banks	55.7	56.7	54.8	43.8	31.1	38.5	34.2
Regionals	N.A	37.2	36.0	40.5	6.8	29.0	32.7
New York City Based	N.A	42.1	43.3	50.7	19.9	31.2	35.4
NYSE Discounters	N.A	52.2	53.9	46.7	0.8	25.6	49.5
Total Industry	49.2	35.9	40.5	36.6	13.3	29.4	28.6

After Tax ROE

Securities Industry*	26.6	19.4	21.9	19.8	7.2	15.9	15.4
S&P 400	N.A	14.9	11.3	12.2	14.6	12.1	11.5

* Assumes a 46% corporate tax rate.

The poorer performance of the 10 LIBs last year was directly responsible for the drop in total industry ROE, which was dragged down to a 28.6% (pre-tax) return for 1986. As with profit margins, all the major firm categories except the LIBs showed year-to-year improvements. The securities industry's ROE still compares favorably to other industries, e.g. its nearly consistent outperformance of the S&P 400 as shown in table 3.

Table 4

STATEMENT OF INCOME
NATIONAL FULL LINE FIRMS

(In \$ Millions)

<u>Revenues</u>	<u>1985</u>	<u>1986</u>	<u>% Change</u>
Commissions	3,523.6	4,517.0	28.2
Trading Profits	4,505.8	5,513.9	22.4
Investment Gains	92.4	20.5	(77.8)
Underwriting	2,074.7	2,947.0	42.0
Margin Interest	1,357.1	1,487.1	9.6
Mutual Fund Sales	1,186.0	2,024.8	70.7
Fees, Account Supervision	397.2	626.2	57.7
Commodities	624.4	737.0	18.0
Other Securities Related	2,585.6	3,652.7	41.3
Other Unrelated	365.6	370.0	1.2
Total Revenues	16,712.3	21,896.8	31.0
<u>Expenses</u>			
RR Compensation	4,137.0	5,498.4	32.9
Clerical Compensation	3,398.1	4,562.4	34.3
Partner/Officer Comp.	204.2	210.1	2.9
Floor (Commission/Clearing)	374.3	452.0	20.8
Communications	1,157.1	1,351.4	16.8
Occupancy & Equipment	1,067.8	1,235.5	15.7
Promotional Costs	500.4	592.6	18.4
Interest Expense	3,187.1	4,006.0	25.7
Errors/Bad Debts	180.2	313.4	73.9
EDP	181.7	229.5	26.3
Non-Recurring Charges	35.6	45.0	26.4
Regulatory Fees	123.9	165.5	33.6
Other	1,225.4	1,715.9	40.0
Total Expenses	15,772.8	20,378.0	29.2
Pre-Tax Net Income	939.5	1,518.8	61.7

NATIONAL FULL LINE FIRMS

The big story for the NFLs in 1986 was that pre-tax profits jumped a hefty 61.7%, from \$940 million in 1985 to \$1.5 billion last year. However, one-third of that profit, or \$572 million, was earned in the first quarter where these 10 firms as a group mustered margins of 10.4%, a feat that they as a group haven't been able to maintain for a full year since 1980, when they showed a 10.9% pre-tax profit margin. When viewed quarterly, that profit margin was cut in half by the time the year was out to 5.3% in Q4 (see Table 5 below). As Table 5 clearly depicts, the NFLs' lowest profit margin during the fourth quarter coincided with record quarterly highs in both revenues and expenses.

Table 5

NFLs' 1986 QUARTERLY RESULTS

(In \$ Millions)

	<u>Q:1</u>	<u>Q:2</u>	<u>Q:3</u>	<u>Q:4</u>
Revenues	5,509.9	5,461.9	5,221.9	5,703.1
Expenses	4,937.7	5,121.3	4,920.5	5,398.5
Pre-Tax Profits	572.2	340.6	301.4	304.6
Profit Margin (%)	10.4	6.2	5.8	5.3

For the year, commissions increased 28% to \$4.5 billion, or 21% of all revenue, the same share as the industry average. Quarterly, commissions eased slightly, and gradually, from \$1.2 billion in Q1 to \$1.0 billion in Q4, or from 22.3% of revenues to 18.3%.

For trading gains, Q1 was also the best quarter. For the year, these gains increased 22% to \$5.5 billion, but about one-third, \$1.7 billion, was booked in Q1 with about \$1.3 earned in each of the remaining quarters. This pattern, a big Q1 and then even, but slightly lower, results for the remaining quarters, matched the trading results of the industry and other major firm categories.

Firms investing for their own accounts (and in their own deals, i.e. LBOs), admittedly is still a small, but growing, business area for most of the NFLs. Though still a small segment (1/2% of 1985 revenues and 1/10% of 1986 revenues), the NFLs' 78% drop in gains from this area, down to \$20.5 million net for the year, was still a damaging shot to many of the NFLs. The market conditions of the "post-Boesky" fourth quarter where most of the damage occurred - these 10 firms had booked a net gain of over \$76 million during the first nine months only to witness most, \$56 million, of that wiped out in fourth quarter losses. Nevertheless, as will be seen later, the LIBs which concentrate a lot of their

capital to this business line were the most adversely affected in the fourth quarter. Despite the violent earnings swings of this inherently risky business line, competitive forces keep pressuring the industry towards these principal activities as a revenue source with more and more firms adding capital to existing "principal" units or starting, building or expanding this area of capital markets providing more and more bridge financings and other merchant banking activities.

The NFLs' underwriting revenues leaped 42% last year from \$2.1 billion to nearly \$3 billion. That was a higher increase than the 27% increase in volume of underwritten corporate and municipal offerings from \$378 billion in 1985 to \$429 billion last year according to Investment Dealers' Digest (IDD, January 12, 1987). The NFLs earned half of all industry underwriting revenues last year. According to IDD, the top 15 lead managers of all domestic corporate offerings last year book-managed over 90% of the \$285 billion underwritten. Of these 15, eight were NFLs and seven were LIBs. For municipals, IDD's top 15 book managers handled two-thirds of the \$144 billion underwritten. Of these, seven were NFL firms, six were LIBs and two, Citicorp and Morgan Guaranty, were banks, each managing 2.2% of the muni volume. Underwriting also contributed to 13.5% of the NFLs' total revenues last year which was up from 12.4% in 1985 and is higher than the industry's 11.9% share for 1986. Also, unlike the other revenue sources already mentioned, underwriting showed its highest quarter in Q4, with one-third, or \$1 billion, posted over those three months. The quarterly story, here again, matched the total industry's.

Margin interest rose a modest 10%. This was only a third of the NFLs' increase in commission revenues. Results improved slightly from quarter to quarter, rising from \$352 million in Q1 to \$382 million in Q4. As pointed out in the previous (March 30) Trends, there were countervailing forces affecting this revenue line for the industry during 1986. Over the 12 months, interest rates in general, as well as for margin accounts, steadily declined about 200 basis points during the period. Concurrently, margin debit balances (for the NYSE group as reported by the NYSE) showed a 37% linear increase, from \$27 billion outstanding in January to \$37 billion in December. This increase in debit balances made the industry's mere 13% growth in margin interest revenues somewhat surprising. Nevertheless, this is still an important revenue source for the NFLs.

The NFLs continued their expansion in mutual fund sales. Last year, revenues from mutual fund sales broached the \$2 billion mark for these 10 firms. That was a 71% increase over 1985, the largest increase of any revenue line. The increase also matched the industry's 71% climb in mutual fund revenues, though that's not surprising since these 10 firms accounted for over 72% of the industry's mutual fund sale revenues. Also, mutual fund sales now account for 9% of the NFLs' revenues, up from 7% in 1985.

Account management and supervision fees was the second largest gainer on the NFLs' revenue sheet, climbing 58% to \$626 million last year. The new emphasis in the industry on asset management, as well as the introduction of more fee-oriented products such as the 12b-1 mutual funds, appears to be paying off. The NFLs' have about half of the industry's revenues from these sources but the industry still broke the billion-dollar mark from these fees last year earning \$1.5 billion, up 55% over 1985's total.

Other securities related revenue, which in the March 30, 1987, Trends was estimated for the industry to be about 23% M&A fees, 21% private placement fees and the balance repos and other securities related revenues for 1986, rose 41% for the NFLs to \$3.7 billion, or 17% of total revenues.

On the expense side of the income statement, the NFLs had large increases in compensation costs but these increases were a little below the increases for the total industry. RR Compensation increased 32.9% to \$5.5 billion, just shy of the 33.0% increase for the industry. An SIA survey, highlighted in March 1987's "Sales and Marketing Notes," analyzed recent changes in firms' sales compensation practices. The NFL firms which participated in the survey had steepened the curve on their RR payout structure by reducing payouts to lower producers. Clerical payroll increased a little faster, 34.3%, to \$4.6 billion while the industry experienced a slightly larger increase of 35.5%. Senior management of the NFLs' kept their compensation increases as a group to under 3% last year vs. a 21% increase within the industry.

The NFLs added about 11,400 employees in 1986, a 9% increase which was slightly under the industry's increase. As can be seen in Table 6, the NFLs now employ just under 140,000 people (yearly average).

Table 6

EMPLOYEES

(In Thousands)

<u>Firm Category</u>	<u>80</u>	<u>81</u>	<u>82</u>	<u>83</u>	<u>84</u>	<u>85</u>	<u>86</u>
National Full Line	81.0	92.9	100.3	112.6	122.5	127.5	138.9
Large Investment Banks	15.8	17.8	19.9	23.9	25.1	27.0	31.0
Regionals	N.A	31.2	31.5	34.3	36.2	35.6	38.0
New York City Based	N.A	10.9	10.9	11.2	11.7	12.4	13.3
NYSE Discounters	N.A	0.6	1.2	1.6	2.1	2.7	3.4
Total Industry	139.8	160.6	171.0	192.0	207.5	214.6	234.2

Table 7 shows that the NFLs still employ about three-fifths of the industry's workforce with the LIBs payroll share growing while other categories' shares are declining.

Table 7

SHARE OF EMPLOYEES

(In Percent)

<u>Firm Category</u>	<u>80</u>	<u>81</u>	<u>82</u>	<u>83</u>	<u>84</u>	<u>85</u>	<u>86</u>
National Full Line	57.9	57.8	58.7	58.6	59.0	59.4	59.3
Large Investment Banks	11.3	11.1	11.6	12.4	12.1	12.6	13.2
Regionals	N.A	19.4	18.4	17.9	17.4	16.6	16.2
New York City Based	N.A	6.8	6.4	5.8	5.6	5.8	5.7
NYSE Discounters	N.A	0.4	0.7	0.8	1.0	1.3	1.5

The NFLs managed to keep the increases in their floor, communications, occupancy, equipment and promotional costs, together totalling almost \$4 billion, much lower than their gains in revenues. All of these items increased from 16% to 21%, much lower than the 31% increase in total revenues.

Despite, as mentioned earlier, a 200 basis point drop in interest rates during 1986, the NFLs' interest expense rose 26% to over \$4 billion. That increase was slightly larger than the 23% increase in interest expense for the industry last year.

The volume crunch in these hectic market times appears to be taking its toll in order processing. Errors and bad debt costs rose 74% for the NFLs in 1986, lopping off over \$300 million that otherwise would have carried to the bottom line. This was 73% of the industry's error/bad debt costs, which, considering the volume handled by the NFLs in relation to other firms, is not all that surprising but is up substantially from their 68% share of these costs the previous year.

Still, total expenses increased 29%, less than the 31% growth in revenues which translated into a nice 62% increase in pre-tax profits to a record \$1.5 billion for these 10 firms.

Table 8

**STATEMENT OF INCOME
LARGE INVESTMENT BANKS**

(In \$ Millions)

<u>Revenues</u>	<u>1985</u>	<u>1986</u>	<u>% Change</u>
Commissions	1,127.1	1,439.2	27.7
Trading Profits	3,876.2	5,152.1	32.9
Investment Gains	409.2	522.6	27.7
Underwriting	1,376.6	1,967.9	43.0
Margin Interest	373.5	483.2	29.4
Mutual Fund Sales	28.7	51.0	77.7
Fees, Account Supervision	171.6	307.9	79.4
Research	0.3	22.4	736.7
Commodities	290.2	235.7	(18.8)
Other Securities Related	3,489.8	3,883.4	11.3
Other Unrelated	951.6	1,195.1	25.6
Total Revenues	12,097.6	15,260.5	26.1
<u>Expenses</u>			
RR Compensation	1,123.3	1,532.6	36.4
Clerical Compensation	1,301.7	1,918.7	47.4
Partner/Officer Comp.	401.4	522.9	30.3
Floor (Commission/Clearing)	219.3	327.2	49.2
Communications	287.4	394.0	37.1
Occupancy & Equipment	317.0	416.0	31.2
Promotional Costs	149.4	204.8	37.1
Interest Expense	5,722.3	6,434.6	12.4
Errors/Bad Debts	24.0	42.7	77.9
EDP	141.0	200.9	42.5
Non-Recurring Charges	7.0	18.8	168.6
Regulatory Fees	34.4	50.3	46.2
Other	615.4	1,129.8	83.6
Total Expenses	10,,332.0	13,193.2	27.7
Pre-Tax Net Income	1,765.6	2,067.3	17.1

LARGE INVESTMENT BANKS

As was already shown in Tables 2 and 3, the LIBs as a group were the only firm category to show deteriorations in their profit margins and ROE during bull year 1986. Table 8 shows how this group's revenues increased 26.1% (compared to 29.7% for the industry) to a record \$15.3 billion. Meanwhile, expenses grew at a faster 27.7% annual clip which left the bottom line's growth a much smaller 17.1%, for a \$2.1 billion pre-tax profit for 1986.

That's a 13.5% profit margin, down from 1985's 14.6% showing, and the second thinnest margin of the Eighties (Table 2), it was lower only during 1984's industry-wide slump year. The growth in expenses for these 10 firms would have been much higher were it not for a tight control on interest expense. This expense item, typically accounting for 50% to 60% of the LIBs' total expenses, accounted for less than half of total expenses last year. Interest expense grew only 12.4% while every line item for the other half of all expenses increased more than 30% each, all outpacing the overall 26% growth in revenues. In fact, non-interest expense increased a whopping 47% for the LIBs going from \$4.6 billion in 1985 to \$6.8 billion last year. Personnel costs, the second biggest expense, were up 41% in total to \$2.8 billion while the clerical payroll portion alone was up 47% to \$1.9 billion. It must be remembered that these figures, aggregated from unconsolidated FOCUS reports, are dealing with domestic operations. The LIBs have also been spending heavily on expansion in international arenas, particularly London and Tokyo, which, if it were possible to combine with their domestic data, would probably drive several of these expense increases even higher.

On the revenue side, commissions, which make up just under 10% of the LIBs' revenues, rose 27.7% last year which matched the industry performance. Commissions didn't fluctuate much quarterly, ranging between \$350 million to \$380 million per quarter. Trading, a full third of all revenues for the LIBs, rose 33% to a record \$5.2 billion last year, outperforming the industry-wide 26% increase. The first quarter was by far the best for trading with over \$1.6 billion posted during that period vs. about \$1.2 billion in each remaining quarter. The LIBs also outperformed the industry's handsome 40% growth in underwriting revenues with these 10 firms posting a hefty 43% increase in this area to a record \$2 billion. On a quarterly basis, the LIBs, having come off a then record \$460 million in underwriting revenues in 1985's final quarter, earned \$446 million in 1986 Q1, then slid a bit to \$430 million in Q2. The industry also came off its record underwriting quarter in Q4 1985, \$1.5 billion, and then posted a lower 1986 Q1, \$1.1 billion. But for the second quarter, unlike the LIBs, the underwriting revenues shot back up to \$1.5 billion and set a new record surpassing 1985's final quarter by exactly \$1 million. For the second half, the LIBs then set and broke their quarterly underwriting revenue record, with \$516 million posted in Q3 and then \$577 million in Q4. The industry also ended the year on a record underwriting revenue quarter with \$1.8 billion taken in.

While the 10 NFLs accounted for half of the industry's underwriting revenues, the 10 LIBs accounted for one-third. Also, as was true for the NFLs as shown earlier, the 43% increase in revenues from underwriting posted by the LIBs far outpaced the 27% increase in total volume of corporate and municipal securities underwritten in 1986 vs. 1985. As was also discussed earlier, seven of the 10 LIBs made the top 15 underwriting ranks for corporate securities and six made this list for municipal bonds.

In account supervision fees, the LIBs followed the same trend as the industry registering a 79% increase to a record \$308 million. That not only followed the industry trend but surpassed the industry's 55% growth in this area and the NFLs' 58% increase. The final quarter was by far the best in this area with more than half, or \$166 million posted over these three months. That was triple the level of any of the other three quarters where fees ranged from \$40 million to \$54 million.

While the industry and the NFLs posted 33% and 41% gains, respectively, in other securities related revenues (M&A, private placements, repos, etc.), the LIBs managed only an 11% increase in this area. Also not helping was a 19% drop in commodities revenues which could have been even worse were it not for a strong final quarter, \$182 million booked or 77% of the year's total.

Saved for last was how the LIBs performed in investing for their own account. This is the "hot" new area that many firms, particularly these LIBs, are targeting for future revenue and profit growth. Taking principal equity positions in deals a firm is acting as investment banker for is growing as a trend and as a profit source. It's betting, and thus risking, a firm's own capital on companies' prospects instead of just on securities business lines and inventory. Earlier we saw how the NFLs' profits in this area were wiped out in the post-Boesky fourth quarter period resulting in a 78% year-to-year drop in revenues from this area. The industry posted a year-to-year increase of a mere 5% from investment gains to \$1.1 billion whereas at mid-year that stood at a higher \$1.2 billion - a lackluster third quarter gain of \$174 million was more than wiped out by a fourth quarter loss in excess of \$200 million.

So, on the surface the LIBs appeared to have fared very well in investing for their own account. This group posted a 28% year-to-year increase in investment gains, outpacing their 26% overall revenue increase. But they also didn't escape the

volatility of this type of activity. In fact 56%, or \$112 million, of that fourth quarter \$200 million loss was caused by these 10 firms. Table 9 shows how cyclical this activity has been for the LIBs on a quarterly basis.

Table 9

LIBs' QUARTERLY INVESTMENT GAINS (LOSSES)

(In \$ Millions)

<u>Quarter</u>	<u>85:1</u>	<u>85:2</u>	<u>85:3</u>	<u>85:4</u>	<u>86:1</u>	<u>86:2</u>	<u>86:3</u>	<u>86:4</u>
Gain (Loss)	94.1	125.6	28.7	160.8	236.0	284.4	115.0	(112.8)

Obviously, this area is unpredictable quarter to quarter but overall the LIBs have been generating sizable revenues from investing for their own account. With over a half billion dollars earned in this area last year by these 10 firms, this trend will continue as so many firms have already stipulated and have already set aside increased amounts of capital specified for principal investing.

Table 10

STATEMENT OF INCOME
REGIONAL FIRMS

(In \$ Millions)

<u>Revenues</u>	<u>1985</u>	<u>1986</u>	<u>% Change</u>
Commissions	1,352.3	1,642.7	21.5
Trading Profits	712.3	929.5	30.5
Investment Gains	57.0	47.7	(16.3)
Underwriting	592.2	711.4	20.1
Margin Interest	277.7	277.7	0.0
Mutual Fund Sales	370.2	659.5	78.1
Fees, Account Supervision	58.6	86.9	48.3
Research	11.0	9.2	(16.4)
Commodities	44.3	46.1	4.1
Other Securities Related	471.3	461.7	(2.0)
Other Unrelated	68.3	95.3	39.5
Total Revenues	4,015.0	4,967.4	23.7
<u>Expenses</u>			
RR Compensation	1,117.2	1,422.2	27.3
Clerical Compensation	711.4	881.0	23.8
Partner/Officer Comp.	273.9	335.6	22.5
Other Compensation*	N.A	86.2	N.A
Floor (Commission/Clearing)	193.6	228.3	17.9
Communications	269.2	307.0	14.0
Occupancy & Equipment	219.4	248.5	13.3
Promotional Costs	104.7	125.7	20.1
Interest Expense	366.5	330.3	(9.9)
Error/Bad Debts	27.6	34.6	25.4
EDP	64.4	75.0	16.5
Non-Recurring Charges	4.8	2.3	(52.1)
Regulatory Fees	33.3	37.2	11.7
Other	249.5	307.4	23.2
Total Expenses	3,636.5	4,421.3	21.6
Pre-Tax Net Income	378.5	546.1	44.3

*From FOCUS Part II-A short form filers, not available prior to 1986

REGIONALS

Although the Regional firms underperformed the industry in terms of total increase in revenues last year, 23.7% vs. 29.7% (Table 10), as a group these firms kept a much better handle on costs, particularly non-personnel costs. The Regionals' costs increased 21.6%, lower than their revenue gain and much lower than the industry-wide 29.3% growth in costs. Thus, these firms turned in a 44.3% increase in pre-tax net income, from \$379 million in 1985 to \$546 million in 1986.

Commission revenues are still the main revenue driver of the Regional firms accounting for a third of all dollars booked. However, last year's 21.5% growth in commission revenues for the Regionals trailed their increases in total revenues as well as the 27.1% industry-wide growth in commissions. Regionals' commission also showed a near linear decline from the first quarter's \$446 million commission intake to the final quarter's \$389 million showing.

For trading profits, the Regionals mustered a better than industry-average 30.5% increase and the quarterly results hovered in a narrow \$240 million to \$280 million range. This area now accounts for 19% of the Regionals' revenues.

For investment gains, the Regionals, unlike the industry and the NFLs and LIBs, didn't book a fourth quarter in the red, but came awfully close with a net gain of merely \$2.3 million in Q4 vs. \$11 million to \$19 million in each of the preceding three. That still brought the annual total in investment gains to only \$48 million, down 16% from the \$57 million earned in 1985.

Underwriting revenues still made up about 15% of total Regionals' revenues but the 20% increase in this area over 1985's results was only half the increase the industry enjoyed. Earlier this year, the SEC, in a report it had commissioned, finally confirmed what was general knowledge...that its Rule 415 had hurt Regional firms' underwriting business, to the tune of \$432,000 in lost underwriting revenues per Regional firm annually. Therefore it's not surprising that, as an example, Regionals accounted for 12% of the industry's underwriting revenues last year vs. 21% in the pre-415 year of 1981. Still, the Regionals followed the industry's quarterly upward trend in underwriting revenues rising from \$140 million in Q1 to a record \$196 million in Q4.

Margin interest revenues for Regionals held steady at about \$70 million per quarter for an annual total of \$277.7 million, exactly matching 1985's results. This compares to 10% and 29% gains for the NFLs and LIBs, respectively, which when combined with Regionals' margin interest, account for four-fifths of the industry's total revenues from this source. As delineated earlier, the year's 200 basis point decline in prevailing interest rates mitigated what may have otherwise been higher results. What is really surprising is that \$278 million result for 1985 and 1986 is

almost half the record \$504 million in margin interest revenues the Regionals posted in 1981 and this has been steadily declining (with the exception of 1984) in aggregate dollars while most other revenue sources keep rising and as a percent of total revenues (see Table 11).

Table 11

REGIONALS' MARGIN INTEREST REVENUES

<u>Year</u>	<u>81</u>	<u>82</u>	<u>83</u>	<u>84</u>	<u>85</u>	<u>86</u>
\$ Millions	503.6	311.4	307.9	400.3	277.7	277.7
% of Total Revenues	18.5	11.1	8.5	12.4	6.9	5.6

For the total industry, 1981 had also stood as the record year for margin interest revenue with \$2.89 billion but last year this was finally exceeded with the new record \$2.92 billion posted. It also must be remembered that interest rates peaked out in 1981: as measured by the prime bank rate, 1981 began with a record 21.5% prime which has since been slashed to almost one-third that level last year. The bottom line is that Regionals controlled 30% of the industry's margin interest business (as measured by revenues) five years ago which has dramatically fallen off to less than 10% last year.

Mutual fund revenues, on the other hand, rose 78% to a record \$660 million for the Regionals last year which did outpace the total industry's 71% gain. "Other securities related" revenues steadily rose from \$96 million in Q1 to \$139 million in Q4.

Total personnel compensation rose 30% for the Regionals last year which was more than the Regionals' revenue gains but less than the 33% rise in personnel costs for the industry.

The balance of the expense sheet showed relative and actual improvements. Errors and bad debt, a relatively small figure for the regionals at \$35 million, rose 25%, slightly more than revenues' 24% gain, but every other expense item increased less than revenues' gains or actually declined. The 18% increase in floor costs was nearly half the 30% industry increase as was EDP costs, 17% vs. 32%. The 14% increase in communications expense was lower than the industry's 19% rise as were the increases in occupancy and equipment costs, promotional expenses, EDP costs, regulatory fees and other expenses. Two categories actually declined: non-recurring charges were slashed in half while interest expense dropped about 10%.

Profits, on a pre-tax basis, fell from a high of \$163 million in Q1, to \$159 million in Q2, to a low of \$98 million in Q3 and then bounced back up to \$126 million in the final quarter.

Table 12
STATEMENT OF INCOME
NYSE DISCOUNTERS

(In \$ Millions)

<u>Revenues</u>	<u>1985</u>	<u>1986</u>	<u>% Change</u>
Commissions	298.6	539.2	80.6
Trading Profits	8.7	9.7	11.5
Investment Gains	2.3	6.8	195.7
Margin Interest	87.4	148.2	69.6
Mutual Fund Sales	3.2	8.7	171.9
All Other	84.6	180.9	113.8
Total Revenues	484.8	893.5	84.3
<u>Expenses</u>			
RR Compensation	23.2	23.1	(0.4)
Clerical Compensation	62.2	112.0	80.1
Partner/Officer Comp.	10.0	16.8	68.0
Other Compensation*	28.7	50.5	76.0
Floor (Commission/Clearing)	56.6	140.5	148.2
Communications	34.6	43.2	24.9
Occupancy & Equipment	33.3	41.8	25.5
Promotional Costs	18.6	22.9	23.1
Interest Expense	75.0	120.9	61.2
Error/Bad Debts	2.4	7.0	191.7
EDP	17.6	40.8	131.8
Regulatory Fees	3.0	4.4	46.7
Other	76.6	129.1	68.5
Total Expenses	441.8	753.1	70.5
Pre-Tax Net Income	43.0	140.4	226.5

NYSE DISCOUNTERS

The following is a brief discussion of the results of the 27 discount brokers (and their subsidiaries) which are members of the New York Stock Exchange. A more detailed study of discount brokers, including the results of approximately another 100 discounters which do not hold Exchange memberships will be the topic of the next issue of Trends.

Commission revenues, which make up 60% of the NYSE Discounters' revenues, rose over 80% in 1986 (Table 12) vs. a 27% increase for all (including the NYSE Discounters) NYSE members dealing with the public. Of course, the group is small but has accounted for around 80% of all identified "pure" discount broker-dealers in the past. Also, a handful of national discount houses account for a "large" portion of the totals, but since not all of these organizations are publicly-held, the exact percentage must remain confidential.

The second largest revenue contributor (other than "other") is margin interest, accounting for about 17% of revenues, which rose 70% during 1986 vs. 13% for the industry.

Both these line items held very steady quarter to quarter. For commissions, the second quarter was the highest with \$138 million in revenues while the remaining three quarters were close behind with \$134 million apiece. Margin interest fluctuated in a narrow range of between \$35 million and \$39 million per quarter.

As can be seen in Table 12, both the larger and smaller areas of Discounter expenses were all up substantially last year. But this came about on substantially increased business and overall was to be expected. But the 71% increase in total expenses trailed substantially the 84% increase in revenues so that the bottom line more than tripled to \$140 million. Last year also catapulted the NYSE Discounters back to the profitability levels they had experienced earlier in the Eighties. Their 15.7% pre-tax profit margin was their highest since 1980's 17.5% showing (Table 2) and their 49.5% pre-tax return on equity (Table 3) was back to the 47% to 54% levels in the years 1981 through 1983.

Table 13

STATEMENT OF INCOME
NEW YORK CITY-BASED FIRMS

(In \$ Millions)

<u>Revenues</u>	<u>1986</u>	<u>% Share of Revenues</u>
Commissions	1,294.0	33.7
Trading Profits	685.1	17.8
Investment Gains	130.5	3.4
Underwriting	184.8	4.8
Margin Interest	166.0	4.3
Mutual Fund Sales	52.4	1.4
Fees, Account Supervision	253.2	6.6
Research	10.1	0.3
Commodities	10.8	0.3
Other Securities Related	965.1	25.1
Other Unrelated	87.3	2.3
Total Revenues	3,839.2	100.0
<u>Expenses</u>		
RR Compensation	478.4	12.5
Clerical Compensation	565.8	14.7
Partner/Officer Comp.	141.2	3.7
Other Compensation	186.0	4.8
Floor (Commission/Clearing)	243.2	6.3
Communications	121.3	3.2
Occupancy & Equipment	132.8	3.5
Promotional Costs	60.9	1.6
Interest Expense	849.5	22.1
Error/Bad Debts	13.4	0.3
EDP	36.8	1.0
Non-Recurring Charges	4.5	0.1
Regulatory Fees	28.3	0.7
Other	357.4	9.3
Total Expenses	3,220.8	83.9
Pre-Tax Net Income	618.4	16.1

NEW YORK CITY--BASED FIRMS

The New York City-based firms (NYCs) are similar in business lines to the Regional firms (which are similar to the NFLs) but are headquartered in New York. They also exhibit some of the characteristics of their larger New York LIB neighbors in terms of leverage (Table 14), and thus higher interest expense, and share of revenues derived from "other securities related" activities, e.g. M&A, private placements and repo activities.

Table 14

LEVEL OF LEVERAGE

(Average Assets to Equity)

<u>Firm Category</u>	<u>80</u>	<u>81</u>	<u>82</u>	<u>83</u>	<u>84</u>	<u>85</u>	<u>86</u>
National Full Line	15X	14X	13X	15X	18X	18X	16X
Large Investment Banks	32	31	34	31	36	42	33
Regionals	9	11	9	8	9	9	7
New York City Based	29	19	13	13	15	14	21
NYSE Discounters	4	6	8	6	7	9	11
Commission Introducing	4	4	4	5	3	2	3
Total Industry	19	18	19	18	22	24	21

As mentioned earlier, last year's recategorization makes it impossible to compare the NYCs' aggregates from its 1986 income statement and balance sheet to prior years but was a necessary change in order to ensure an up-to-date proper classification of NYSE firms.

However, ratio analysis is still possible and the NYCs' pre-tax profit margin of 16.1% last year was their second best of the Eighties, only exceeded by bull-year 1983's 18.3% showing (see Table 2). Also, last year's pre-tax ROE of 35.4% was the second year of improvement in this parameter, but still falls short of the 41% to 52% ROEs shown earlier in the Eighties (Table 3).

Table 13 outlines the percentage breakdown of revenues and expenses to the NYCs' 1986 total revenues. The two biggest (other than "others") revenue sources for the NYCs are commissions and trading profits, as is true for Regionals. The NYCs and Regionals both earned a third of their revenues from commissions and 18% from trading. As was true with the LIBs last year, the NYCs' "other securities related" revenues made up a quarter of all revenues. Also, as was true for LIBs, the biggest single expense item (counting each personnel cost category as separate) was interest expense, although the NYCs' 22% share of revenues is only half that of the LIBs' share.

The NYCs' commissions tapered off slightly from quarter to quarter dropping from \$334 million in Q1 to \$296 million in Q4. The same was true for trading gains which fell from their high of \$231 million in Q1 to \$140 million in Q4. The NYCs didn't escape the problems in the second half for investments either - the \$130.5 million showing for the year is exactly where they stood at the end of June.

Profits showed quarterly deterioration also. Pre-tax net fell quarter-to-quarter as follows: \$258 million, \$146 million, \$113 million, \$101 million. Though not linear, this was due to increasing expenses eating into decreasing revenues.

Table 15

STATEMENT OF INCOME
COMMISSION INTRODUCING FIRMS

(In \$ Millions)

<u>Revenues</u>	<u>1986</u>	<u>% Share of Revenues</u>
Commissions	417.9	59.7
Trading Profits	84.9	12.1
Investment Gains	23.5	3.4
Underwriting	29.2	4.2
Fees, Account Supervision	58.0	8.3
Commodities	9.4	1.3
All Other	76.8	11.0
Total Revenues	699.7	100.0
<u>Expenses</u>		
Total Employee Compensation	202.6	29.0
Floor (Commission/Clearing)	68.8	9.8
Interest Expense	16.2	2.3
All Other	257.5	36.8
Total Expenses	545.1	77.9
Pre-Tax Net Income	154.6	22.1

COMMISSION INTRODUCING FIRMS

The final major SIA/SEC firm category (other than "other") is Commission Introducing firms (CIs). These are all the non-carrying, non-clearing (other than the few classified as Regionals, NYCs or Discounters) which file the short Part II-A FOCUS Report. Although they are the largest group in number, about 114 firms, they are small firms which are basically brokers clearing through larger firms and only account for about 1.4% of industry revenues. As shown in Table 15, the bulk, 60%, of their revenues comes from commissions, as would be expected.

The CIs profit margins in both 1985 and 1986 were the highest of all firm categories (Table 2) and rose from about 20% to 22%. As interest expense's mere 2.3% slice of revenues would indicate, this is the least leveraged group of firms, as their business nature allows, averaging assets of only three times equity last year (Table 14).

CAPITAL EMPLOYMENT

The industry, as defined by the NYSE firms doing a public business, has witnessed a six-fold increase in capital from January 1, 1980, when it stood at \$5 billion, through the close of 1986, standing at \$30 billion, a period of seven years. On average, industry capital has increased 30% annually over this time frame with the largest annual increase coming last year - up 36%.

Sources of this capital have been various and discussed extensively in recent years: the equity portion of capital has been boosted by brokerages going public particularly the larger IPOs (Bear Stearns, L.F. Rothschild, Morgan Stanley, etc.), growing retained earnings over this protracted bull cycle plus the equity and subordinated liability infusions from parent organizations, most importantly the insurers and financial service conglomerates (American Express, Sears, etc.). As discussed earlier, the capital requirements of targeting "principal" activities in the securities industry has been the driver in this quest for capital.

This quest, as the 36% increase of industry capital indicates, has accelerated in recent years and is a response to the generally accepted notion that principal activities will generate multiple returns on the additional capital employed. However, Table 16 surely indicates that the returns on lower levels of capital employed in the early Eighties, about 30% on a pre-tax basis, have fallen to the 20% range on much higher levels of industry capital employed over the past few years. Of course, not all capital is employed in financing principal activities, but these activities have become not only the predominant revenue generating business lines of the industry today but continue to be the favored target for future growth (Trends data/analysis, again, focuses on domestic arena only).

Table 16

PRE-TAX RETURN ON CAPITAL

(In Percent)

<u>Firm Category</u>	<u>81</u>	<u>82</u>	<u>83</u>	<u>84</u>	<u>85</u>	<u>86</u>
National Full Line	14.9	23.3	23.0	(2.0)	11.8	15.8
Large Investment Banks	47.3	44.5	36.9	24.9	29.2	24.4
Regionals	64.8	29.5	35.4	5.8	24.1	29.3
Total Industry	29.0	32.3	30.7	10.4	21.4	21.3

Table 16 also shows that the major firm categories, as well as the industry in general, also are not achieving the same return on capital they enjoyed in earlier years.

ROOM FOR IMPROVEMENT

If the industry is to improve its margins what can it target on the expense side for reductions? Table 17 delineates where every dollar of revenue is used by industry and firm category.

Table 17

FIRM ANALYSIS OF 1986 COMPENSATION, INTEREST, ALL
OTHER COSTS AND PROFITS, % SHARE OF REVENUES

(Percent of Total Revenues)

<u>Firm Category</u>	<u>Compensation</u>	<u>Interest</u>	<u>Other Costs</u>	<u>Profits</u>
National Full Line	46.9	18.3	27.9	6.9
Large Investment Banks	26.0	42.2	18.3	13.5
Regionals	54.9	6.6	27.5	11.0
New York City Based	35.7	22.1	26.1	16.1
NYSE Discounters	22.7	13.5	48.1	15.7
Commission Introducing	29.0	2.3	46.6	22.1
Total Industry	38.7	24.8	25.5	11.0

Interest expense accounts for one quarter of all industry revenues. Also, the more leveraged a firm is (see Table 14), the more revenues are devoted to covering this leverage. Compensation eats up more than a third of the industry's revenues also, ranging from 23% for Discounters to 55% for Regionals.

Compensation and interest therefore take this share of total revenues for the following: total industry - 63.5%; NFLs - 65.2%; LIBs - 68.2%; 61.5%; NYCs - 57.8%. Only the Discounters and CIs pay out a relatively small share of their revenues to these two areas, 36% and 31%, respectively. Having a bigger balance after compensation and interest to work with, it's not surprising these two groups muster the biggest profit margins.

At any rate, Table 17 capsulizes what firms in each category have to work with in targeted areas for expense management to get their margins up.

George R. Monahan

Assistant Director of Research

Table 18

INCOME STATEMENT DEFINITIONS FROM THE FOCUS REPORT

REVENUES

COMMISSIONS: Commissions from all agency equity and debt transactions (including closed-end but excluding open-end mutual funds).

TRADING PROFITS: Realized and unrealized gains and losses on securities held for sale in the ordinary course of business (net of dividends and interest earned on such securities).

INVESTMENT GAINS: Realized and unrealized gains and losses on securities identified as held for investment (exclusive of dividends and interest earned on such securities).

UNDERWRITING: Gross profits and losses from management of and participation in underwriting syndicates and selling groups (purchase vs. sales price adjusted for discounts, commissions and allowances paid or received).

MARGIN INTEREST: Interest income earned on customers' securities and commodities accounts.

MUTUAL FUND SALES: Total income from sales of investment company securities as a retailer or underwriter (includes net amount of sales load and commissions from installment sales but excludes commissions from closed-end funds).

FEES: Total fees for account supervision, investment advisory and administrative services.

RESEARCH: Revenues from the sale of research services (including income from the sale of research advice (other than as investment advisor), research reports, market letters, stock guides, portfolio analyses, and other publications and consultations).

COMMODITIES: Income from commissions, fees, and principal trading in commodities (including futures and spot contracts).

OTHER SECURITIES RELATED: Other income related to the securities business includes, among other things, private placement fees, proxy solicitation fees, service charges (such as for mergers and acquisitions), fees for options done away from an exchange, dividends and interest from investments (including repos and reverse repos), subscription fees for periodic publications (exclusive of research).

OTHER UNRELATED: All other revenues not related to securities business.

EXPENSES

RR COMPENSATION: Total compensation to registered representatives (individuals that spend 50% of their time effecting transactions with public customers) including: salary, commission or other basis.

CLERICAL COMPENSATION: All Salaries, commissions bonuses, profit sharing, payroll taxes and benefits for all employees other than RRs, voting stockholder officers and general partners.

PARTNER/OFFICER COMPENSATION: Total salaries and employee benefits for voting stockholder officers and general partners.

OTHER COMPENSATION: Non-carrying or clearing firms' salaries, commissions, bonuses, profit sharing, payroll taxes for all employees other than voting stockholder officers or general partners.

FLOOR EXPENSES: All commissions and floor brokerage fees paid to other brokers and all clearance fees paid.

COMMUNICATIONS: Expenditures for telephone, telegraph, leased wires, tickers and projectors, quotation machines, NASDAQ, postage, stationary, and office supplies.

OCCUPANCY AND EQUIPMENT: Expenditures for rent, heat, light, maintenance, repair to premises, janitorial and cleaning expenses.

PROMOTIONAL COSTS: General advertising and promotional expenses.

INTEREST EXPENSE: All interest payments other than those credited to general and limited partners' capital.

ERRORS/BAD DEBTS: Losses in error accounts and bad debts.

EDP: Rental and depreciation of data processing equipment (other than service bureau).

10.5. 1987-1986 UNRECORDED

CORPORATE FINANCING (Gross New Issues - \$ Mils)		FIRST QUARTER 1987	FIRST QUARTER 1986	% Change 1987-1986
TOTAL		\$87,726.5	\$68,040.2	28.9%
Common Stock		\$11,512.1	\$8,689.8	32.5%
# of Common Stock Issues		204	205	-0.5%
Preferred Stock		\$4,367.0	\$3,832.9	13.9%
# of Preferred Stock Issues		55	59	41.0%
Corporate Debt		\$71,847.3	\$55,517.5	29.4%
# of Corporate Debt Issues		646	548	17.9%
MUNICIPAL FINANCING (Gross New Issues - \$ Mils)				
Negotiated		\$24,221.5	\$9,427.5	156.9%
# of Issues		654	300	118.0%
Competitive		\$4,965.8	\$3,865.5	28.5%
# of Issues		608	405	50.1%

Source: IDD Information Services

VOLUME

	MARCH 1987	YTD 1987	MARCH 1986	YTD 1986	% CHG. YTD 1987-1986
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	180.3	185.6	160.8	148.1	25.3%
AMEX (MILS.)*	15.7	15.2	15.9	13.7	11.0%
NASDAQ (MILS.)*	151.7	154.6	129.9	120.7	28.1%
REGIONAL EXCHANGE (MILS.)*	28.0	28.4	27.9	25.2	12.7%
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	\$166,316	\$472,549	\$123,896	\$337,321	40.1%
AMEX (MILS.)	5,441	15,150	4,126	10,378	46.0%
ODD-LT SHARES PURCHASED ON NYSE (THOUS.)	12,442	34,004	10,348	26,867	26.6%
ODD-LT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	21,236	57,475	21,782	59,516	-3.4%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	52.9%	51.2%	49.0%	49.4%	---
CONTRACTS TRADED (THOUS.)					
CBOT OPTIONS	16,723	51,460	16,395	47,472	8.4%
AMEX OPTIONS	4,522	13,299	4,347	12,713	4.6%
COMMODITY	16,657	48,664	15,139	47,182	3.1%

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE

PRICES
(END OF MONTH)

MARCH 1987	MARCH 1986	% CHAN. Y-T-D 1987-1986
2304.69	1818.61	26.73%
291.70	238.90	22.10%
165.89	137.71	20.46%
332.66	270.03	23.19%
267.88	242.23	10.59%
430.05	374.72	14.77%

DOW JONES INDUSTRIALS
STANDARD & POOR'S 500
NYSE COMPOSITE
AMEX MARKET VALUE INDEX
VALUE LINE COMPOSITE
NASDAQ COMPOSITE

RECENT INTERESTING READING AND STATISTICAL MATERIAL

<u>Item</u>	<u>Description</u>	<u>Source</u>
<u>Sources</u> 1987-1988 Edition	Securities industry executive's guide to products and services. The guide consists of listings and display ads covering 70 different categories from accounting firms and clearing houses to training institutions and video production.	SIA Publications Department Price: \$5.00
"The New Wall Street"	Comprehensive 2-part article tracing the developments which have shaped Wall Street since May Day. Interviews with industry executives review Wall Street's move from adviser to creator of deals.	New York Newsday 5/3-5/4/87
A Stock Transfer Tax: Preliminary Economic Analysis	Report analyzes three aspects of the tax as proposed by House Speaker Wright: 1. effect of the tax on the stock market, 2. revenue effects of the tax, and 3. incidence of the tax. Develops position that the tax could cause trading volume to decline by 12.7% and stock market prices to drop by 9.3%. In addition, the drop in volume and value would undermine the \$17 billion estimate of revenue gain from such a tax.	Report No. 87-278 S Congressional Research Library of Congress Washington D.C. 20540
"First-Quarter Financing Rankings"	Quarterly rankings, with lead article focusing on development of the mortgage-related debt market. For the first quarter, the \$31 billion issued in mortgage-related debt equals 36% of total domestic corporate underwritings, compared with 16% at the same time last year. Lead manager in this market is Salomon Brothers (21.8%), followed closely by First Boston (20.5%). Statistical tables include comparison with 1Q 86 rank.	Investment Dealers' Digest 4/6/87

<u>Item</u>	<u>Description</u>	<u>Source</u>
"Indexing goes global"	In 1985, less the 1% of the estimated \$25 billion in U.S. pension money committed internationally was indexed. By the end of 1986, reportedly 10% of the estimated \$45 billion in international pension monies was indexed. Article points out the pros and cons of international indexing and discusses the development of this product with various firms.	<u>Institutional Investor</u> 4/87
"The Prospects For Tax Stability"	Former head of Tax Analysis Division of CBO argues that for at least the next five years, the prospects for tax stability are much greater than anyone extrapolating from recent experience might expect. Several factors which could lead to tax changes are examined. Conclusion: what is now known argues against major tax legislation, but the political agenda changes as economic and political realities change.	<u>Tax Notes</u> 4/13/87
<u>Fact Book 1987</u>	NYSE's 32nd edition of fact book presenting comprehensive statistical data on 1986 activity, including concise listing of records set, most active stocks, consolidated tape volume in NYSE-listed stocks for all participating markets, and new listings and removals of common stock.	NYSE, Inc. Market Data Products 11 Wall Street New York, NY 10005 Price: \$5.00
"The Forbes 500"	Annual ranking of largest U.S. companies, in terms of sales, profits, assets and market value. GM is the sales winner but Exxon takes the lead in net profits.	<u>Forbes</u> 4/27/87

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DISCOUNTERS' DOZEN YEARS

A dozen years have elapsed since "May Day," May 1, 1975, when the final curtain fell on fixed commission rates. Although discounting and discounters existed prior to that date, this is generally considered the dawn of discounters. Today, discounting is a fact of life for virtually all firms in the securities business. The banking industry is also very much involved in this business. This Trends is an attempt to study the performance of those broker-dealers which are primarily involved in the discount brokerage business. Lack of data prevents studying the growth of discounting, per se, by all firms engaged in securities commission business.

HIGHLIGHTS

1. No matter which interval of years analyzed, or the group of discounters and methodology used, studies have consistently shown discounters improving their share of retail commissions.
2. The profitability of discounters is at least as volatile as that of the total industry. Over the most recent 16 quarters, half the time profits went up, half the time they fell.
3. Discounting is a highly concentrated segment of the securities industry and growing more so. Five firms accounted for 83% of the revenues of all NYSE discounters last year, up from 81% in 1985. These same five accounted for 68% of total revenues of all discounters in 1986, up from 65% the previous year.
4. Discounters' profitability last year outpaced the securities industry. The pre-tax profit margin for discounters was 15% vs. 12% for the industry and their pre-tax return on equity was 46% vs. 29% for the securities industry.

PREFACE

One of the prime reasons that this publication, Trends, was conceived and, indeed, continues today, is a relative void regarding data about the securities industry. Possibly nowhere is that void greater than on data covering discount brokers.

Four years ago, in the March 4, 1983, issue of Trends, we published "A Primer On Discount Brokers," in an effort to fill the discount broker data void, particularly after the Securities & Exchange Commission discontinued supplying data on discounters after its 1980 annual staff report on the securities industry.

In subsequent issues of Trends, updated data on discount brokers were included in those issues dealing with securities industry profitability by firm category. Such reports explore the revenues, expenses, profits, ROE, etc., of different categories of the NYSE member firms which deal with the public. The figures are derived from the quarterly FOCUS reports submitted to the Exchange.

These groups, known as SIA/SEC categories, are familiar to the long-term Trends' reader. Examples are the National Full Line firms, Large Investment Banks, Regional firms, etc.

The discounter group, as with the other categories, dealt with those discounters which were members of the New York Stock Exchange (dealing with the public). The discounters which are members of the NYSE, however, are relatively few in number (currently 27 parent firms), and therefore SIA has, and continues to, expand this firm category to include firms which are not members of the Big Board. Although the number of NYSE discounters is few, historically the NYSE discounters have accounted for the vast majority, about four-fifths, of the aggregate financials of all discount brokers which SIA has identified at different points in time.

The aggregates of all discounters (registered broker-dealers, including their subsidiaries, whose sole or primary business is discount brokerage) were obtained with the assistance of the National Association of Securities Dealers (NASD), from the FOCUS reports filed by their sole members. In the past, as well as in this issue of Trends, whenever total (NYSE and NASD) discounter figures are compared to total industry figures, SIA also expands its "total industry" figures to include both NYSE and NASD (exclusive of double-counting) members which deal with the public. Other than discounter studies, SIA restricts its analysis of securities industry profitability to NYSE-member firms. (This is due to the timeliness and accessibility of data from this group and its overwhelming share of all securities business conducted in the U.S.)

The continuity of SIA's data on discounters is limited in some areas. During the 1980s, and most recently last year, the

SIA/SEC firm categories were periodically updated to reflect added and dropped memberships. This updating also ensures that a firm's classification represents its current business nature and the classifications, themselves, have been adjusted to reflect user demand. This has resulted in a few categories being eliminated, such as clearing firms.

All data in this report for periods 1983 and thereafter reflect the adjusted numbers for the new group of discounters and any comparison of these periods to prior periods warrants caution. Aggregate data is the most affected but ratios, i.e. profit margins, should be affected to a much lesser extent.

Finally, attempts to identify market share of discounters involved assumptions made by the SEC in its reports and assumptions by SIA in Trends.

Thus, the following analysis is made complex by both the number of various data sources which must be tapped, the changes in players identified as conducting discount brokerage businesses as well as the assumptions which were necessary to measure the changing markets.

Nevertheless, the following analysis of the discount brokerage business and its impact and share of total securities businesses is the most detailed and complete publicly available analysis about this group that we know of.

THE EARLY YEARS

A dozen years have passed since the U.S. securities industry's "May Day," May 1, 1975 when the final curtain fell on fixed commission rates. Although certain commission rates were allowed to be negotiated prior to that date and broker-dealers also engaged in the business of discounting prior to that date, this is generally considered the dawn of discounters - A.D. vs. B.C. or After Discounting vs. Bound Commissions, if you will.

As reported in a previous issue of this publication concerning discounters, in the 1970's, the U.S. securities industry underwent significant changes in structure, concentration, and diversification of revenue sources. Most of these changes resulted from economic forces which were driving up prices and interest rates. This, in turn, led to dramatic changes in the demand for services and products provided by the securities industry. Until 1979, there was a sharp decline in the number of securities firms dealing with the public, increasing concentration (the market share of the largest 10 and 25 firms increased noticeably), and a de-emphasis on commission business. With the sharp increase in market volume since 1977, some, but not all, of these trends have moderated. While concentration continued to increase and commission revenues declined in relative importance, the number of NYSE firms doing a public business stopped falling and even increased slightly.

Some, but not all, of these trends were intensified by the SEC's decision to eliminate fixed commission rates on May 1, 1975. This regulatory change reduced the profitability of the institutional brokerage business as institutional rates quickly plunged from their pre-May Day levels.

The demise of institutional research houses was swift and striking. There was also a decimation of the brokerage house ranks following Mayday, but it was more confined to the institutional sector. Retail firms did encounter difficulties in 1977, but these problems stemmed more from poor markets than from the advent of competitive rates.

In the institutional sphere, proprietary trading is viewed as an independent profit center, in no conceivable sense as an adjunct to institutional brokerage as it once was. Hard-dollar research revenues remain negligible, while there appears still to be adequate research coverage of both companies and markets. Liquidity and research were the most important soft-dollar services in the pre-May Day business. They are also services which discount brokers, by and large, do not offer.

The unfixing of commission rates allowed for a new competitive strategy to be employed in offering retail brokerage services. Some new firms entered the industry primarily to attract retail business by offering commission charges well below prices of more established firms. Others already in the business as traders and market-makers or specialist firms became discounters. Such firms used discount brokerage as an opportunity to augment their other operations. Few, if any, of the largest, well-established firms chose to operate solely as a discount broker in terms of market strategy.

For discussion purposes, it is useful to define precisely what is meant by the term "discount broker." Discounters operate almost entirely in the retail business; institutional investors, conscious of both their market power and fiduciary obligations, invariably demand (and get) from full service firms execution at rates well below those that prevailed in April 1975. A "pure" discounter offers only execution, although a variety of services can be found in the discounter field, as discussed below. This discounter execution service is usually offered at a discount of roughly 40-70% off the April 1975 fixed rate level. Discounters are distinguished, too, by their lack of an active sales force, which creates an emphasis upon mass media advertising and execution of unsolicited orders.

As mentioned, discount brokerage existed prior to May Day but the opportunities were very limited. Prior to 1975, broker-dealers discounting commissions on brokerage transactions for retail customers were limited to offering discounts from fixed rates on over-the-counter (OTC) trades or operating as agents between clients and "third market" dealers

(firms making markets in listed stocks who were not members of exchanges). The elimination of fixed rates on May 1, 1975 expanded opportunities for discount brokers considerably by making it possible for exchange members to offer discounted commission rates on transactions in exchange-listed stocks and by enabling non-member brokers to negotiate access to exchanges at lower rates.

When the Securities & Exchange Commission reported on discount brokers in its Staff Report on the Securities Industry in 1978, it identified 35 discounters in existence prior to May 1, 1975, four new firms later that year, nine additions in 1976, four more in 1977 and three additions in 1978. When the SEC revisited the topic in its Staff Report for the year 1980, it identified 70 broker-dealers considered discount brokers which had been established prior to 1976, 12 new entrants in 1976, eight in 1977, nine in 1978, 15 in 1979 and 11 new entrants in 1980, the last year for which the SEC tracked this group of firms (see Table 1).

Table 1

BROKER-DEALERS OPERATING AS DISCOUNTERS

<u>Year</u>	<u>Original</u>	<u>Revised</u>
1975	39*	70
1976	44	82
1977	48	90
1978	51	99
1979	NA	114
1980	NA	125

*The Staff Report for 1978 stated that of the 39, 35 were in existence prior to May 1, 1975, of which only eight had been in existence in 1968.

SOURCE: SEC's Staff Reports on the Securities Industry in 1978 (original) and 1980 (revised).

Though the methodology used by the SEC has on occasion been critiqued, and the problems with tracking this elusive sector of the industry lends itself to criticism from any who attempt to quantitatively assess this industry segment, the following is an outline of the SEC's data on discounters in their initial post-May Day years, before the advent of bank discounters.

DISCOUNTERS' DAWN

Agency commission business was on the rebound in the latter half of the 1970s. Commission revenues in 1977 stood at nearly

the same level as five years earlier. For this discussion on discounters, we'll begin by using the revised figures published by the SEC in 1981, in its Staff Report on the Securities Industry in 1980, the last time the SEC addressed discounter data. As Table 2 shows, industry commissions took off in 1978, up by a third, then increased over 10% the following year and shot up by two-fifths in 1980. Meanwhile, discounters experienced even higher growth in commission revenues, averaging over 50% annual growth in commission revenues over this same time span and showing a remarkable 77% climb in 1980 alone vs. 41% for the industry.

According to the SEC's 1980 figures, discounters' share of industry commissions grew from a 2.3% share in 1977 to 3.8% in 1980. Using their estimates of how much commission revenues were a result of retail business (which held steady at around two-thirds), discounters' market penetration rose from 3.5% in 1977 to 5.7% in 1980 (market penetration defined as share of retail commissions with discounters' commissions assumed to be 100% retail).

Although the number of discounters increased from 90 to 125 over this time frame, the aggregate and growth figures were not materially affected by the new entrants. The 90 firms in existence in 1977 accounted for the vast majority of revenues and virtually all of the profits during these years. The new entrants after 1977, although encouraged into the discounting business by the profitability of the established discounters, as a group lost money in their early years. The nine firms established in 1978 as a group didn't reach their break-even point until 1980 and those established later still hadn't reached their break-even point by 1980's close. Even the 12 firms established in 1976 and the eight firms established in 1977 took until 1978 to reach their break-even point as a group.

When the SEC looked at discounters in its Staff Report for 1978, the commission revenue totals were only 40% to 50% the level of the revised larger group. However, that smaller group of firms was reporting 86% to 88% of all their revenues as commission revenues. The new, larger group of firms in the Staff Report for 1980, showed commissions as 62% of their 1979 and 1980 revenues (this ratio unavailable for earlier years).

In comparison, the securities industry derived about 42% of its revenues from commissions in 1977 and 1978 and about 34% the next two years. For the National Full Line firms (NFLs), the large nationwide retail houses whose retail customer base is largely the targeted customer base of discounters, commissions constituted half of all revenues in 1977, 43% in 1978, 44% in 1979 and only 37% by 1980.

Table 2

DISCOUNTERS' EARLY GROWTH
(Dollar Amounts in Millions)

	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>
Industry Commissions	\$3,035.0	\$4,036.0	\$4,512.0	\$6,377.0
Discounters' Commissions	\$69.8	\$102.8	\$136.5	\$241.0
Discounters' Share	2.3%	2.5%	3.0%	3.8%
SEC's Estimated Industry Retail Commissions	\$1,982.0	\$2,736.0	\$3,023.0	\$4,234.0
Discounters' Market Share of Retail Commissions	3.5%	3.8%	4.5%	5.7%
Commissions' Growth:				
Industry	N.A	+33.0%	+11.8%	+41.3%
Discounters	N.A	+47.3%	+32.8%	+76.6%
Number of Discounters	90	99	114	125

The smaller group of firms showed pre-tax profit margins of 5.1% in 1980 vs. 6.2% for the industry and 15.6% in 1981 vs. 7.7% for the industry. The NFLs had margins of only 4.4% and 6.9% in these two years. Although profit margins for the larger group are unavailable for these years, the revised figures also show discounters outpacing the industry in profit margins in subsequent years: discounters with pre-tax profit margin of 10.5% vs. the industry's 9.8% in 1979 and discounters with 16.6% vs. the industry's 14.1% in 1980. Meanwhile, the NFLs lagged both again with margins of 7.2% and 10.9%, respectively.

PICKING UP THE BALL

By 1981, the advent of discounters was over, the impact of negotiated rates had been studied and restudied and thus most of the brouhaha was over. The SEC discontinued analyzing this industry segment but demand for data on discounters did not diminish. As mentioned, this continues to be one data area insatiable demand persists on - and thus this follow-up SIA study on these firms.

In early 1983, SIA attempted to maintain the continuity of the discounter data previously published by the SEC ("A Primer on Discount Brokerage," Trends, March 4, 1983) in order to fill this void. Table 3 links the last two years of the SEC's updated figures (1979 and 1980) with SIA's follow-up for the years 1981 and 1982, utilizing the methodology used by the SEC in 1981.

The attempt to maintain the continuity of data and follow the SEC's methodology was not 100% successful since the universe of discounters had to be redetermined and assumptions on estimated retail commissions had to be revised. Therefore direct comparisons of years 1981 and 1982 to prior years should be approached with caution.

Table 3

DISCOUNTERS IN 1981 AND 1982
(Dollar Amounts in Millions)

	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>
Industry Commissions	\$4,512	\$6,377	\$6,143	\$6,454
Discounters' Commissions	\$ 137	\$ 241	\$ 251	\$ 314
Discounters' Share	3.0%	3.8%	4.1%	4.9%
Estimated Industry Retail Commissions	\$3,023	\$4,234	\$3,987	\$3,743
Discounters' Market Share of Retail Commissions	4.5%	5.7%	6.3%	8.4%
Industry Revenues	\$13,219	\$18,594	\$22,631	\$24,959
Discounters' Revenues	\$ 220	\$ 389	359	\$ 448
Discounters' Share	1.7%	2.1%	1.6%	1.8%
Commissions' Growth:				
Industry	+11.8%	+41.3%	-3.7%	+5.1%
Discounters	+32.8%	+76.8%	+4.1%	+25.1%
Revenues' Growth:				
Industry	N.A	+40.7%	+21.7%	+10.3%
Discounters	N.A	+7.7%	-7.7%	+24.8
Number of Discounters	114	125	131	136

Table 3 shows that the securities industry experienced a 21.7% growth in revenues in 1981 although commission revenues fell 3.7%. This was a continuation of the industry trend where commissions become less and less a major share of total revenues each year: down to 27% in 1981 from 34% in 1980. Discounters, however, showed a small drop in revenues, 7.7%, while a small rise in commissions, 4.1%.

Part of this discounter change is most likely due to the previous mentioned changes needed to pick up the SEC's ball on discounters. Note that discounters' commissions in 1981 and 1982 are back up as a percent of total revenues, 70%, from the

SEC's 1979 and 1980 showing of 62%. The estimated retail portion of total commissions for the industry in 1981 remained fairly constant with the SEC's 1979 and 1980 estimate of around two-thirds. With the changes in mind, the data shows discounters increasing their market share of retail commissions to 6.3% in 1981 despite an overall drop and a percentage share drop in revenues.

For 1982, several parameters remained steady. The securities industry's commissions represented 26% of total revenues vs. 27% the previous year. Discounters' commissions again constituted 70% of their revenues. What did change was the estimated portion of industry commissions which came from the retail segment, 58%, down from 65% in 1981.

Discounters' revenues and commissions jumped 25% from 1981 levels while industry revenues rose 10% and commissions rose half that rate.

Therefore, discounters' share of industry revenues and commissions both rose while their market share, as measured by share of industry retail commissions, continued its upward march hitting 8.4%, as measured in the March 4, 1983, Trends.

Another attempt at refining the group of discounters was attempted in the Fall of 1983. This affected the figures for 1982 but did not attempt to retroactively adjust the discounter data. Since the reader has already encountered numerous versions of annual data in this report, the following will, just for the record, highlight the attempted adjustments as published in Trends, November 25, 1983.

Total industry revenues and commissions were determined to be about 10% higher than reported earlier but industry commission revenues were still 26% of total revenues. The new group of 159 discounters reported aggregate revenues and commissions at a level of around 20% below what was reported earlier and the share of discounters' revenues attributable to commissions was slightly lower at 67%. The estimated portion of industry commissions attributable to the retail market was lower at 44% and thus the discounters' market share, defined as a percent of this industry retail commission business, was also lower at 6.3%.

The preceding was a review of various past attempts at analyzing discount broker dealer data. One more attempt has been made by SIA to analyze this industry segment. The following is an analysis of a redefined group of discounters and their performance over the past four years.

A DECADE AFTER MAY DAY

In late 1986, SIA again attempted to identify those broker-dealers (both NYSE and NASD members) which were primarily engaged in the discount brokerage business. This

group does not contain the deposit taking institutions which are engaged in discount brokerage as an adjunct to their banking business (and are not subject to SEC review and thus do not file the regulatory FOCUS report from which SIA gathers its data). The primarily engaged requisite means that this report, as was true with the SEC's Staff Reports, does not analyze the growth in discounting per se, but analyzes the growth in the business conducted by those discounters identified in 1986.

Discounting has become a way of life for virtually all firms doing a retail business and it is impossible to track the percentage of business conducted by all broker-dealers, such as National and Regional firms, which was transacted on a discount basis. Therefore, even if a broker-dealer does a majority of its retail business on a discount basis, if that discount business is not the broker-dealer's primary business (e.g. investment banking and principal businesses contribute a significant percentage of total revenues), they are not classified as a discounter. Also, discounters operate discount brokerage clearing subsidiaries as an adjunct to their business (such as Fidelity's National Financial and Quick & Reilly's Q&R Clearing) and the revenues from these operations, clearly a large and important part of discounters' operations today, are included in this analysis.

The group of firms identified as being primarily discount brokers in 1986 were identified from previous lists, directories of broker-dealers, advertisements, numerous assistance from discounters and their own research on discounters, and many hours on the telephone with brokerages to verify the list.^{1/}

Despite the fact that different groups of discounters were used in various reports and various estimates were employed to determine industry retail commissions, each report, including the following shows similar trends. The first is that the agency commission business becomes a smaller part of total revenues each year for the securities industry. Commissions were more than half of industry revenues in the early 1970s, fell to around 29% of revenues in 1983 and were down to around 22% last year. Commissions themselves are not shrinking, in fact commission revenues have reached record levels for the past two years, but they are growing at slower rates than other revenue sources, mainly principal business.

^{1/}Special thanks to all who helped make this study possible, particularly a few dedicated friends at the NYSE, the NASD and at Fidelity.

Discounters, however, have kept their commission to total revenue ratio pretty steady since 1983 at around 60%. They also have had higher rates of growth of commission revenues than the industry as a whole over this period. Even in 1984 when the industry experienced a slump, discounters fared better in commission revenues: discounters' commissions fell only 3% from 1983's levels vs. an 11% drop for the industry.

Table 4

DISCOUNTERS
(\$ Millions)

	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
Commissions	335.3	325.9	443.0	654.5
Revenues	529.9	595.1	770.0	1,096.8
Expenses	467.6	589.1	701.3	933.5
Pre-Tax Net Income	62.3	6.0	68.7	163.3

(% of Revenues)

Commissions	63.3	54.8	57.5	59.7
Expenses	88.2	99.0	91.1	85.1
Pre-Tax Net Income	11.8	1.0	8.9	14.9

(% Change)

Commissions	N.A	(2.8)	35.9	47.7
Revenues	N.A	12.3	29.4	42.4
Expenses	N.A	26.0	19.0	41.7
Pre-Tax Net Income	N.A	(90.4)	1,045.0	137.7

(% Share of Total Industry)

Commissions	3.4	3.7	4.2	4.9
Revenues	1.5	1.6	1.6	1.8
Pre-Tax Net Income	1.4	0.3	1.3	2.3
Estimated Retail Commissions*	5.1	5.6	6.4	7.3

No. of Firms	106	120	117	122
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*Retail commissions are estimated to be two-thirds of total commissions.

Table 5

TOTAL INDUSTRY
(\$ Millions)

	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
Commissions	9,840.4	8,763.3	10,432.9	13,430.1
Revenues	34,336.4	37,048.0	46,844.3	61,017.7
Expenses	29,810.7	34,908.5	41,459.2	53,905.5
Pre-Tax Net Income	4,525.7	2,139.6	5,385.1	7,112.2
(% of Revenues)				
Commissions	28.7	23.7	22.3	22.0
Expenses	86.8	94.2	88.5	88.3
Pre-Tax Net Income	13.2	5.8	11.5	11.7
(% Change)				
Commissions	N.A	(10.9)	19.1	28.7
Revenues	N.A	7.9	26.4	30.3
Expenses	N.A	17.1	18.8	30.0
Pre-Tax Net Income	N.A	(52.7)	151.7	32.1
No. of Firms	4,027	4,867	5,714	6,387

While discounters' revenue growth was outpacing the industry, so was the growth in their expenses. In 1984, discounters' expenses increased 26% outstripping a 12% growth in revenues for a 90% drop in profitability. This resulted in a razor thin pre-tax profit margin of only 1%. The industry also saw a drop in profitability but less severe, down 53% vs. discounters' 90% fall. The industry profit margin was slashed also to 5.8%, but that's still much higher than the discounters' 1%. Even the previous year, 1983, discounters' profit margin was below the industry average, 11.8% vs. 13.2%. Meanwhile, the National firms fared even worse, dropping into the loss column in 1984 from a relatively low profit margin stance of 8.6% in bull market year 1983.

As the market returned to good times in 1985, discounters pretty much mirrored the performance of the total industry. Gains in revenues for discounters, NFLs and the industry all rose around 26% to 29%. In all cases, this outpaced by a good margin increases in expenses which averaged 19% to 20% for these three categories of firms. But by just mirroring this performance, it still left the discounters' profit margins sitting somewhere between that of the NFLs and the total industry. Discounters' margins were 8.9% vs. 11.5% for the industry and 5.6% for the NFLs.

Last year was a phenomenal year for the securities industry. Improvements in businesses, profits, and profitability ratios were felt in most segments of the

securities industry. Retail activity on the New York Stock Exchange shot up 25% while on the Amex it rose 55%. Since the listed equities business makes up about two-thirds of the discounters' commissions, this was bound to translate into higher revenues. Discounters' commissions rose 48% while overall revenues climbed 42%. Clearly, in 1986 discounters increased their penetration of this growing commission business. The total industry's commission revenues rose a lesser 29% as did their total revenues, up 30%. The NFLs followed a similar growth pattern as the total industry experienced.

Discounters' share of total commissions climbed from 3.4% in 1983 to 4.9% last year. Their share of revenues and profits also peaked last year. Based on informal surveys of SIA member firms, we estimate that two-thirds of industry commissions are from the retail area. This pretty much matches the previous SEC estimates. And while discounters' commissions are not 100% retail, they are not very much south of that mark and therefore in estimating discounters' share of retail commissions we will again use all discounters' commissions vs. our estimate (two-thirds of total) of industry retail commissions. This shows discounters' market penetration of the retail commission business climbing from 5.1% in 1983 to 7.3% last year. While earlier reports showed this level already eclipsed, again these figures are from a revised list which we feel is substantially correct for "pure" discounters.

The growth in expenses for these groups only slightly lagged each group's revenue gains. However, while the discounters' showed the biggest growth in expenses, their high growth in revenues allowed them to not only improve their profit margins the most, they also showed a higher margin than the industry, the first time they managed this over these four years: discounters' pre-tax profit margin hit 15% vs. the industry's 12% and NFLs' 7%.

Using another measure of profitability, pre-tax return on equity capital (ROE), shows that relative to the whole spectrum of securities firms, discounters were also mirroring overall trends in the brokerage industry for the years 1983 through 1985. Only last year, again, did discounters really show any quantum leap in performance relative to all brokers.

Table 6

PRE-TAX RETURN ON EQUITY
(In Percent)

	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
Discounters	35.8	2.7	26.2	45.6
Total Industry	34.6	14.0	29.8	28.8
National Full Line	28.1	(2.6)	17.9	20.3

The volatility of the profitability of the discount brokerage business at least equals the volatility for the industry. As a colleague once said, in trying to predict whether profits will be up or down for the securities industry in any given quarter from the previous quarter, you have just as much chance of being correct if you flip a coin as you would if you spent months on regression analysis.

Over the past 16 calendar quarters, discounters experienced eight quarters with rising profits and eight with falling profits. The industry fared only slightly better: nine were up, seven were down.

Though 1986 was the record year for both discounters and the total industry, it was largely a success based on the first quarter results. This was also true for the industry, but not as dramatic. This year's first quarter, however, will eclipse 1986's first quarter. Based on the NYSE discounters (making up 80% of total discounter data), new records in commissions, revenues and profits will be set (this holds true for the total industry as well). The projection for Q1 1987 is that discounters' share of total commissions will rise to 5.3%, to 2.1% of total revenues and to 2.8% of total pre-tax profits.

CONCENTRATION

There is one overriding factor which must be kept in mind when analyzing or utilizing the preceding data on discounters, and that is the concentration within this industry segment. The securities industry itself is a concentrated industry. Last year, the 10 largest capitalized firms accounted for 57% of total revenues of NYSE member firms (dealing with the public). They also accounted for almost half of the total revenues of all NYSE and NASD member firms.

When it comes to discount brokers, the concentration level is even higher. Last year, five discounters accounted for 83% of the revenues of NYSE discounters. They also accounted for 68% of the revenues of all discounters. Concentration increased from 1985 when these two figures were a slightly lower 81% and 65%, respectively.

CUSTOMERS & DEMOGRAPHICS

According to Market Facts, Inc., in the latest of its studies on discounters, "Discount Brokerage Update '87," at the beginning of this year 3.6% of U.S. households have an active discount account. That was double the level for 1983, only 1.5%. Comparing that to Bureau of the Census figures, households with any type discounter account grew about 150% since 1983, going from around 1.3 million households to 3.2 million by January, 1987. The study also found that an additional 11% of households had used a discounter in the past but not currently and 85% of households have never used a discounter.

As mentioned earlier, the bread and butter revenue source for discounters is commissions and of that listed equity business is king. Also shown earlier was that discounters were gaining in this area relative to the total industry and their competitors. Market Facts' survey supports this trend. It found that 58% of all the transactions of clients of discounters only were in corporate stocks. That stacked up against 52% for clients of full service firms only and 49% for clients with any type brokerage account. The next highest type of product was mutual funds which accounted for about 16% of all transactions regardless of what type brokerage account was used.

When it came to the proportion of all dollars, the difference was even more striking. Market Facts shows 76% of transaction dollars from clients with only a discounter account come from corporate stocks vs. 41% from clients with just a full service account and 36% for any brokerage account.

That NFLs (as well as Regional and other type full service firms) are competing with discounters is supported by the Market Facts study. In their "Update '86" study, Market Facts breaks down the type of firms used by the households with a current account at any type of discounter. Of these clients, 52% had a current account with a nationwide discounter while 54% also held current accounts with full service firms. These discount clients also held accounts with banks and thrifts, 42%, while only 18% had current accounts with local independent discounters. Using these figures for nationwide vs. local discounters only, it shows 75% of this smaller group have accounts at the nationwide discounters. This supports the concentration figures shown earlier.

Finally, although the geographic breakdown of discounters by number of offices is unavailable, we can look at these discounters by the states in which they are headquartered. New York was number one with 29 discounters headquartered there (all but five of which were in New York City); Florida's unique demographics placed it second with 13 discounters ahead of California's 11; Texas was fourth with seven while Missouri and Massachusetts tied for fifth with a half dozen discounters each.

CONCLUSION

No matter the interval of time measured nor the group of firms and methodology used, it is clear that discounters have continuously increased their share of the retail commission business relative to the total industry. This is partly due to the fact that discounters, by their nature, are still primarily in the retail commission business while the industry has more

and more turned to principal and investment banking businesses as their primary revenue source. As noted, the total securities industry derived more than half of its revenues from commissions in the early 1970s which has dwindled to around one-fifth today.

Jeffrey M. Schaefer
Senior Vice President and
Director of Research

George R. Monahan
Assistant Director
of Research

VOLUME

	APRIL 1987	YTD 1987	APRIL 1986	YTD 1986	% CHAN YTD 1987-1986
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	187.1	186.0	147.3	147.9	25.8%
AMEX (MILS.)*	14.4	15.0	13.7	13.7	9.5%
NASDAQ (MILS.)*	144.3	151.9	128.2	122.6	23.9%
REGIONAL EXCHANGE (MILS.)*	28.2	28.3	23.8	24.8	14.1%
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	\$172,672	\$645,221	\$128,376	\$465,697	38.5%
AMEX (MILS.)	4,369	19,519	4,299	14,677	33.0%
ODD-Lot SHARES PURCHASED ON NYSE (THOUS.)	13,140	47,144	11,307	38,174	23.5%
ODD-Lot SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	19,575	77,050	21,151	80,667	-4.5%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	49.2%	50.7%	49.1%	49.3%	---
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	18,715	70,175	17,755	65,227	7.6%
AMEX OPTIONS	4,766	18,065	4,724	17,437	3.6%
COMMODITY	23,203	71,867	17,338	64,520	11.4%

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE

UNDERWRITING

	APRIL 1987	APRIL 1986	% Change 1987-1986
CORPORATE FINANCING (Gross New Issues - \$ Mils)			
TOTAL	\$21,526.0	\$33,608.8	-36.0%
Common Stock: # of Common Stock Issues	\$3,212.5 79	\$5,038.5 111	-36.2% -28.8%
Preferred Stock: # of Preferred Stock Issues	\$644.5 8	\$871.0 14	-26.0% -42.9%
Corporate Debt: # of Corporate Debt Issues	\$17,669.0 192	\$27,699.3 251	-36.2% -23.5%
MUNICIPAL FINANCING (Gross New Issues - \$ Mils)			
Negotiated # of Issues	\$7,513.9 113	\$11,249.3 157	-33.2% -28.0%
Competitive # of Issues	\$2,140.9 102	\$4,119.0 135	-48.0% -24.4%

Source: IDD Information Services

PRICES
(END OF MONTH)

APRIL 1987	APRIL 1986	% CHAN YTD 1987-1986
2286.36	1783.98	28.16%
288.36	235.52	22.44%
162.86	135.75	19.97%
325.19	268.97	20.90%
259.21	238.60	8.64%
417.81	383.24	9.02%

DOW JONES INDUSTRIALS
STANDARD & POOR'S 500
NYSE COMPOSITE
AMEX MARKET VALUE INDEX
VALUE LINE COMPOSITE
NASDAQ COMPOSITE

RECENT INTERESTING READING AND STATISTICAL MATERIAL

Item

Comparison of Individual
Taxation of Long- and
Short-Term Capital Gains
on Portfolio Stock In-
vestments in Seventeen
Countries

Description

Through the Tax Reform Act of 1986, both short- and long-term capital gains will be subject to a 28% (33% in some cases) tax rate beginning 1/1/88. However, although the taxation of short-term gains has been reduced, the U.S. still maintains capital gains rates that are generally higher than 11 major foreign industrial and six Pacific Basin countries surveyed. This SIA-commissioned Arthur Andersen survey explains capital gains taxation in foreign countries and compares results in a concise table.

Report on Production &
Earnings of RRs in 1986

SIA's 14th annual report based on input from 60 member firms employing over 52,000 salespeople across the country. The average production of retail RRs hit a record \$243,845 in 1986, while institutional RRs' production came in at \$1,094,159. The 87-page Report contains detailed data on production, average payout percentages, RR earnings, and branch managers' compensation.

"The Largest Money Managers"

The nation's 100 largest money managers reported a healthy 22.4% increase in total assets under management and a 23% increase in tax-exempt assets in 1986. Extensive rankings and detailed directory of money managers, including size of assets managed, chief officers, and general portfolio mix.

Source

SIA
Publications Department

SIA
Surveys Department
SIA members: \$ 400
Non-members: \$1,200

Pensions & Investment Age
Special profiles issue
5/25/87

Item

"The Big Bet--The Dilemma of Bridge Financing"

Description

For securities firms, making a bridge loan -- a short-term loan made by an investment bank to fund the initial cash portion of a LBO or recapitalization -- is the ultimate gamble on its own ability to sell the company's junk bonds at a later time to pay itself back. For corporations, bridge loans are so quick and easy that they are becoming less a financing technique of last resort and more like a commodity service that clients expect to get from any investment bank. Investment bankers discuss the high risks and rewards of bridge financing.

Source

Investment Dealers' Digest
6/1/87

"Uncommon Convertibles"

Deciding whether to invest client funds in a company's common stock or a convertible bond is not a simple matter. The attraction of the CB relative to the stock is that it almost always offers a higher yield and yet also offers the potential for capital gains if the market value of the stock should rise. Article explains steps to determine whether to invest in the CB or common stock of a company.

Registered Representative
May 1987

"The Way It Was"

A history of the past 20 years offered by over 100 industry leaders who have shaped the current global financial community. Contributing to this retrospective collection are Walter Wriston, David Rockefeller, Bernard Cornfeld and James Needham, among others.

Institutional Investor
20th Anniversary Issue
June 1987



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HIGHLIGHTS

The Growth In Primary And Secondary Activity In International Markets

- International issuers and investors find alternative means of financings preferable to traditional bank financings. "Securitized" financings, which accounted for 44.1% of funds raised on the international financial markets in 1982, now account for 87%.
- Despite the five year bull market, U.S. equity markets have lost considerable ground to foreign equity markets and now account for only 39% of worldwide market capitalization compared to 61% in 1975.
- Since 1980, foreign net purchases of U.S. Treasuries averaged \$17 billion per year, reducing the upward pressure that "crowding out" would have had on U.S. interest rates.
- U.S. corporations are taking to international markets in increasing numbers to raise both debt and equity capital.
- During the 1980s, broker-dealers expanded their sales forces overseas rapidly.

**THE GROWTH IN PRIMARY AND SECONDARY ACTIVITY
IN INTERNATIONAL MARKETS**

This issue of Trends will summarize a recently completed SIA study, The International Market: Growth In Primary and Secondary Activity. The purpose of the study was to detail the expansion of global capital markets.

Due to the study's length, this issue of Trends will only cover sections on worldwide equity market capitalization, foreign trading in U.S. securities, Euroequity offerings, Eurobond offerings, pension fund flows and deregulation. The full study includes additional information on foreign exchange turnover, the swap market, derivative products, mutual and country funds and Euronotes and Eurocommercial paper.

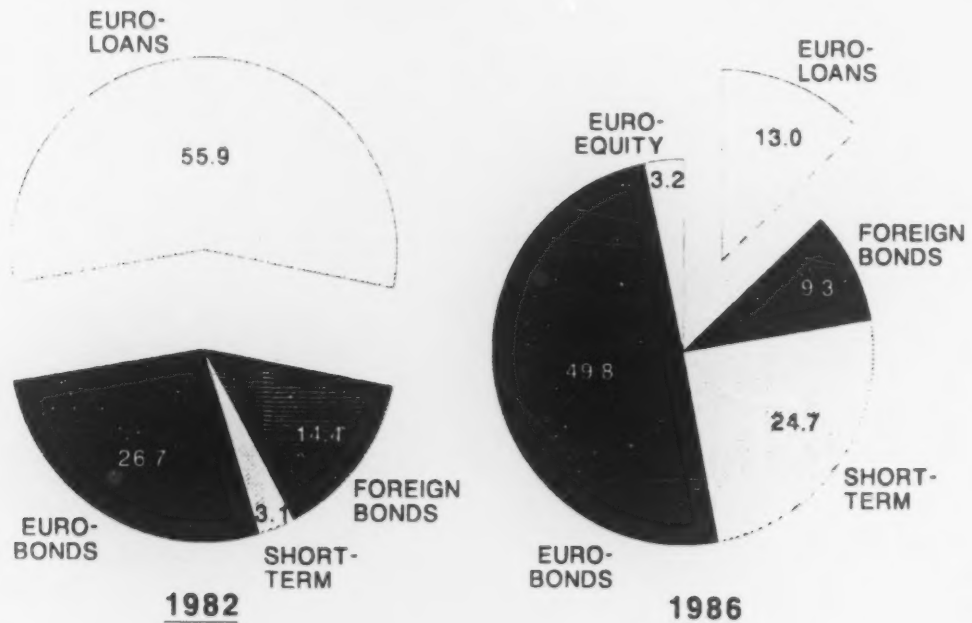
Copies of the full study can be acquired by completing the attached (blue) order form.

The dramatic growth in primary and secondary activity in international markets began in the 1970s, when high inflation and skyrocketing nominal interest rates began to make traditional bank intermediation, such as loans, an increasingly unattractive vehicle to both lenders and borrowers. Issuers in the 1980s, with a global bull market and the experiences of the past decade well in mind, turned to securitized financings as a more flexible and attractive way to borrow. Investors also benefitted, as they were offered a myriad of products through which they could meet their specific portfolio needs.

The following graph underscores the trend toward "securitized" products: in 1986, "non-securitized" products accounted for 13.0% of funds raised in the international financial markets, down a whopping 42.9 percentage points from the 55.9% market share in 1982.

Not surprisingly, U.S. broker-dealers have built upon their fundamental domestic strengths and expertise, along with distribution and capital, to match the demanders and suppliers of global capital. In this regard, U.S. broker-dealers have been busy setting up and expanding overseas offices and services to meet the needs of clients in the international markets.

COMPARISON OF SECURITIZED TO NON-SECURITIZED
PRODUCTS, 1982 vs. 1986



WORLDWIDE EQUITY MARKET CAPITALIZATION

Changes in the market capitalization of different stock markets throughout the world emphasizes the increased opportunities available in stock markets outside the U.S. As the table indicates, other countries, in particular Japan, have been gaining ground rapidly over the past few years. During the past 12 years, U.S. markets have seen their share of the world's equity capital shrink from over 61% to just over 39%.

Reduced regulation in foreign markets has played a role in lessening the dominance of U.S. exchanges. The combined impact of deregulation and the offering of government owned companies to the public, privatization programs, has made some foreign markets more attractive relative to the U.S. market while simultaneously increasing their capitalization. Some of the recent decline in the relative dominance of U.S. exchanges has been due to a strengthening of foreign currencies relative to the U.S. dollar; this is particularly true of the Japanese yen.

STOCK MARKET VALUE, EXCHANGE-LISTED DOMESTIC COMPANIES
(\$ Billions)

	-----MARKET VALUE-----				----% Of Total----		
	1975	1980	1985	1986	1975	1985	1986
United States*	\$ 704	\$1,237	\$1,946	\$2,199	61.2%	48.6%	39.2%
Japan**	142	379	948	1,784	12.3	23.7	31.8
United Kingdom	86	205	353	473	7.5	8.8	8.4
Germany	51	72	184	258	4.4	4.6	4.6
Canada***	51	118	157	185	4.4	3.9	3.3
France	35	55	79	153	3.0	2.0	2.7
Italy	11	25	58	140	1.0	1.4	2.5
Switzerland	17	43	84	129	1.5	2.1	2.3
Australia	20	60	60	94	1.7	1.5	1.7
Netherlands	18	29	59	84	1.6	1.5	1.5
Sweden	2	13	37	63	0.2	0.9	1.1
Belgium	9	10	21	37	0.8	0.5	0.7
Denmark	4	6	15	17	0.3	0.4	0.3
Total	\$1,150	\$2,252	\$4,001	\$5,616			

Source: Salomon Brothers Inc and International Federation of Stock Exchanges

* Excludes value of domestic listed companies on NASDAQ and Regional Exchanges.

** Excludes value of domestic listed companies on the Osaka Exchange.

*** Excludes value of domestic listed companies on the Montreal Exchange.

The growth of non-U.S. equity markets has important implications for U.S. and other broker-dealers. The performance of these markets eventually had to catch the eye of portfolio investors and persuade them to at least diversify some part of their portfolios in those markets growing the fastest. Hence, to accommodate such needs, U.S. broker-dealers have had to increase their research facilities and trading capabilities in foreign stock markets.

FOREIGN TRADING IN U.S. SECURITIES

A much more explosive catalyst to the growth of international markets has been the interest by foreigners in U.S. securities of all kinds. Foreign investors have a long

history of investing in U.S. securities markets. For instance, as far back as the 1950s, foreign holding of U.S. equities was about 3% of the market value of NYSE listed shares.

The 1980s have witnessed advances in technology that have allowed for the geographical separation of borrower and lender, growing trade imbalances and a trend toward deregulated markets unparalleled in history.

Simultaneously, the major financial markets have been blessed with low rates of inflation and downward trending interest rates, making financial assets more attractive relative to physical assets. These changes unleashed forces resulting in the explosive growth in international capital flows, much of which found its way into U.S. securities. The downward trending dollar, beginning in the autumn of 1985 and continuing through the first quarter of 1987, has made the purchase of U.S. financial assets "easier on the foreign investor's wallet." Not surprisingly, foreign investors were net purchasers of a record \$86.4 billion worth of U.S. securities in 1986.

U.S. Treasury Notes & Bonds

Historically, the U.S. Treasury market has offered investors the largest and most liquid and efficient government bond market in which to trade. These market-oriented characteristics, coupled with the political and economic stability of the U.S., cause foreign investors to consider U.S. Treasuries a relatively safe investment.

GROSS ACTIVITY IN U.S. TREASURIES BY FOREIGN INVESTORS



Foreign investors' activity in U.S. Treasuries exceeded \$2 trillion in 1986, nearly greater than all the activity generated during 1980 through 1985 combined. To service such a large market, U.S. securities firms have found it worthwhile to build up extensive trading and sales networks to inform their foreign customers about the desirability of investing in

FOREIGN GROSS ACTIVITY IN U.S. TREASURY
NOTES & BONDS
(\$ Billions)

-----GROSS-----							
	CANADA	JAPAN	SINGAPORE	SWITZER- LAND	UNITED KINGDOM	WEST GERMANY	<u>ALL</u>
1986	57.1	570.8	41.5	50.0	443.9	56.6	2,064.6
1985	41.9	172.5	41.1	18.4	187.6	31.0	967.2
1984	20.7	30.5	36.4	8.7	87.6	25.3	450.7
1983	6.9	16.5	20.0	5.8	43.8	13.3	254.2
1982	2.2	12.8	12.1	4.1	37.2	14.2	174.6
1981	1.7	10.1	2.5	1.2	28.9	12.1	121.8
1980	1.0	6.6	0.2	1.7	33.0	7.0	97.4
1975	0.3	0.3	N/A	0.006	1.1	0.3	15.8
1972	0.6	3.8	N/A	0.002	0.7	N/A	5.4

FOREIGN NET ACTIVITY IN U.S. TREASURY
NOTES & BONDS
(\$ Billions)

-----NET-----							
	CANADA	JAPAN	SINGAPORE	SWITZER- LAND	UNITED KINGDOM	WEST GERMANY	<u>ALL</u>
1986	0.8	3.8	0.6	0.4	4.7	7.8	24.3
1985	(0.2)	17.9	1.6	0.8	(2.0)	1.9	29.0
1984	1.5	6.1	1.4	0.6	5.2	3.0	21.4
1983	0.7	2.3	(1.2)	0.04	2.0	3.7	5.4
1982	0.09	0.8	1.9	0.7	(0.02)	5.3	17.3
1981	0.07	1.3	0.02	0.01	(0.6)	1.1	15.0
1980	0.22	(1.7)	0.004	(0.4)	0.9	(2.9)	4.9
1975	(0.3)	(0.2)	N/A	0.003	(0.1)	0.2	2.0
1972	0.4	2.7	N/A	0.001	*	N/A	3.3

N/A Not Available

* Less than one million

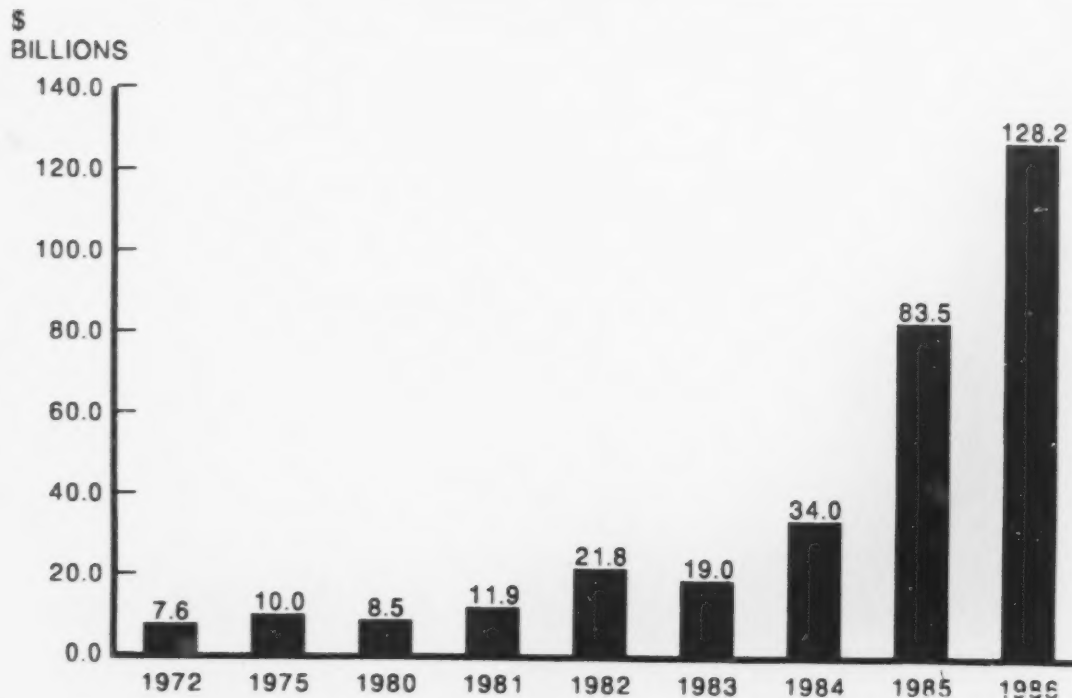
Source: U.S. Treasury

Treasuries. Part of the increase in Treasury activity by foreigners was due to the significant appreciation in the price of Treasuries during 1986. In addition, volatile interest and foreign exchange rates added to the velocity at which these instruments were traded. Finally, the increase in the use of Treasury options and futures domestically and internationally increased the desirability in trading U.S. Treasuries.

A look at the preceding table shows two interesting aspects of the U.S. Treasury market: 1) commensurate with the burgeoning U.S. budget deficit, foreign activity also has increased; and 2) Japanese penetration into the U.S. Treasury market is a fairly recent phenomenon according to "official" data sources.

Until 1984, U.K. investors' gross activity in U.S. Treasuries was generally three times that of Japanese investors. In 1985, however, this "trading gap" closed significantly and, in 1986, Japanese investors surpassed U.K. investors as the most active traders of U.S. Treasuries. Japanese investors, armed with huge capital surpluses and a liberalization of the policies which limited non-yen investments in institutional portfolios, most certainly will sustain this increased activity for the foreseeable future.

**GROSS ACTIVITY IN U.S. CORPORATE DEBT BY
FOREIGN INVESTORS**



U.S. Corporate Debt

Spurred on by heavy domestic and Eurobond issuance by U.S. corporations in 1984-1986, foreign gross and net activity in U.S. corporates grew substantially. In addition, the repeal of the foreign withholding tax on interest payments in 1984 increased the appeal of U.S. corporate debt to foreign private investors.^{1/}

Gross activity, which reached \$128.2 billion in 1986, is over 1400% greater than 1980's \$8.5 billion. In addition, net purchases of corporates have been on the rise since 1983.

FOREIGN GROSS ACTIVITY IN U.S. CORPORATES (\$ Billions)

	-----GROSS-----				
	UNITED KINGDOM	WEST GERMANY	SWITZER- LAND	JAPAN	<u>ALL</u>
1986	71.5	10.6	9.5	12.8	128.2
1985	45.7	7.7	6.4	6.5	83.5
1984	13.9	4.3	2.7	1.9	34.0
1983	5.0	3.1	2.3	1.3	19.0
1982	5.5	4.6	1.3	1.1	21.8
1981	2.7	1.5	0.8	0.4	11.9
1980	1.5	0.7	0.6	0.1	8.5
1975	3.7	0.2	0.5	0.1	10.0
1972	2.8	0.3	0.9	0.3	7.6

FOREIGN NET ACTIVITY IN U.S. CORPORATES (\$ Billions)

	-----NET-----				
	UNITED KINGDOM	WEST GERMANY	SWITZER- LAND	JAPAN	<u>ALL</u>
1986	32.8	(.3)	4.5	5.1	43.5
1985	30.5	2.1	3.9	3.0	39.8
1984	8.7	1.6	0.6	0.7	11.9
1983	0.2	0.2	0.6	0.5	10.9
1982	0.1	1.9	0.2	(0.1)	1.8
1981	0.5	0.7	0.1	0.2	3.5
1980	0.1	0.2	0.1	0.01	2.9
1975	(0.1)	(.01)	0.1	(0.05)	0.8
1972	0.4	0.08	0.1	0.3	1.9

Source: U.S. Treasury

^{1/}The growth in foreign activity in U.S. corporates is somewhat misleading. Starting with 1985, U.S. Treasury data incorporated Eurobond issues into the corporate bond flows for the first time. However, due to the reasons noted above, substantial growth no doubt occurred.

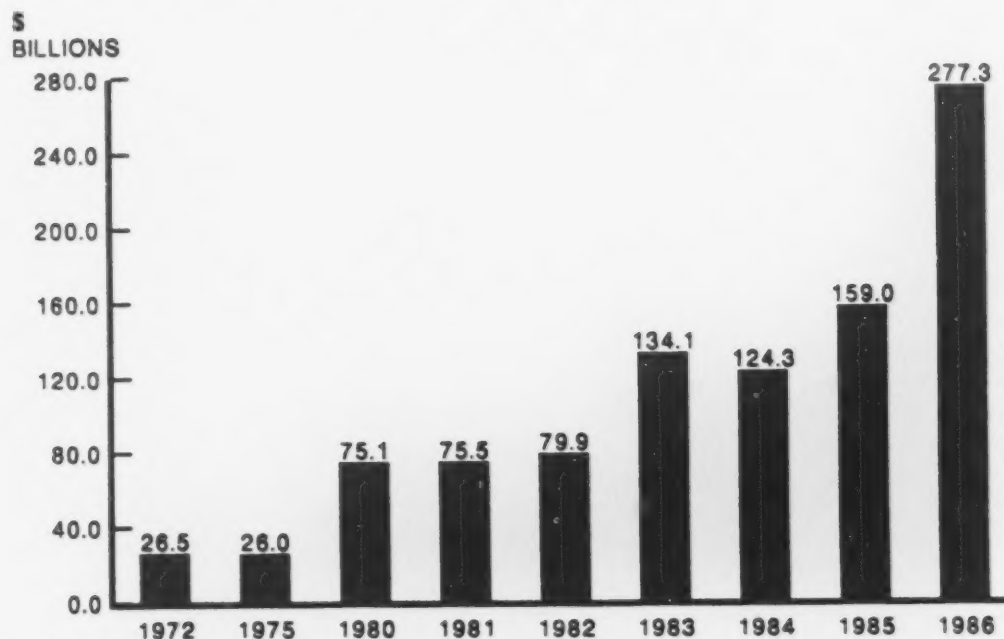
This inflow into the corporate sector helped to lessen the "crowding out" effect by government borrowing which would otherwise have driven interest rates higher. Interestingly, while most attention has been given to net purchases of U.S. Treasuries, foreign net purchases of U.S. corporates have outpaced that of Treasuries during 1985 and 1986 according to official data sources.

U.S. Equities

Foreign activity in U.S. equities also has shown significant growth since the beginning of the 1980's. Gross activity by foreigners has shown a 269% increase when comparing 1980 to 1986.

Foreigners' gross activity in U.S. equities seems to follow a trend: a plateau is reached, gross activity levels off and then a new plateau is reached. For instance, in 1980 to 1982 foreign gross activity stayed in a relatively steady range, averaging \$77 billion. The period 1983 to 1985 saw gross activity increase to an average of \$139 billion and in 1986 topped the scales at \$277 billion.

GROSS ACTIVITY IN U.S. EQUITIES BY FOREIGN INVESTORS



From 1982 on, U.K. investors have shown the most interest in U.S. equities. Prior to U.K. investors, the Swiss were most active (yet showed little in the way of net purchase/net sale activity). Recently, Canadian and especially Japanese investors have shown interest in U.S. equities. The traditional interest by foreigners in U.S. equities explains the original setting up of branch offices overseas, particularly in Europe. However, it appears that the growth in foreign interest in U.S. Treasuries and corporate securities has had more of an impact on the expansion of U.S. firms' trading, sales, operations and other personnel areas overseas than the traditional product line of U.S. equities.

EUROEQUITY OFFERINGS

Continuing record levels of Eurobond issuance overshadow growth in the Euroequity market. However, the equity market is quickly moving from a basically domestic market to an international one. For example, Euromoney's list of international equity issues (issues traded on a daily basis on at least one market outside its home market) has increased from about 240 in 1983 to 493 in 1986. While the tremendous increase in secondary market equity flows is impressive, growth in the Euroequity primary market has been just as substantial. As the table below indicates, almost \$12 billion was raised through Euroequity offerings in 1986. This is over double that issued during the period 1983 to 1985.

EUROEQUITY OFFERINGS, 1983-1986 (\$ Billions)

		<u>Issued By U.S. Corporations</u>	
	<u>Total</u>	<u>Total</u>	<u># Of Issues</u>
1986	\$11.8	\$1.65	33
1985	3.5	0.08	3
1984	1.2	0.03	1
1983	0.2	0.00	0

Source: Euromoney

Not surprisingly, continued growth in Euroequity offerings are leading U.S. and other financial intermediaries to add overseas corporate finance staff with expertise in equities as a means of raising capital in the primary markets as well as creating a distribution network to place this capital.

EUROBOND OFFERINGS

The explosion in Eurobond market financing in the period 1980 to 1986 led many to first take notice of a mature and

growing market. As one of the world's premier capital markets, Eurobond issuance totaled \$183 billion in 1986, with secondary market activity exceeding \$3 trillion. U.S. broker-dealers play a significant role in this market; since 1982, they have accounted for over 35% of the volume of Eurobond offerings.

EUROBOND OFFERINGS, 1982-1986
(\$ Billions)

1986	\$182.8
1985	134.5
1984	78.6
1983	47.3
1982	46.8

Source: IDD Information Services

As Eurobond issuance has grown, so has activity in secondary market trading activity in Eurobonds. Secondary market activity in Eurobonds exceeded \$3 trillion in 1986; in 1982, this figure stood under \$1 trillion. This enormous increase in activity, which in large part takes place in the U.K., has been one of the factors determining U.S. broker-dealer growth in London. The growth in the Eurobond market, both in primary issuance and secondary market trading, has probably been the most important factor in U.S. broker-dealers building up staff and adding to facilities in London. Naturally, as they have added to their production staff, the need for support staff has increased dramatically as well. The Eurobond market probably has been the most important factor in the necessity of U.S. firms having extensive facilities overseas and competing for international business.

U.S. TRADING IN FOREIGN SECURITIES

With U.S. exchanges accounting for about 39% of the world's equity capitalization, U.S. investors have begun to realize that a portfolio need not only represent U.S. companies. U.S. investors have recently shown an increasing desire for foreign equities; such diversification of U.S. investors' portfolios can decrease risk while increasing return.

Foreign Equities

U.S. gross and net activity in foreign securities has a long history but only recently has it blossomed. In the period 1970 to 1978, U.S. gross activity in foreign equities averaged about \$4 billion a year (with a low in 1970 of \$2 billion and a high in 1978 of \$6.8 billion), or only about 16% of the \$25.3 billion averaged by foreign investors' in U.S. equities.

However, in 1979, U.S. gross activity in foreign equities moved up to over \$10 billion and, except for a blip in 1982, has trended upwards reaching \$101.3 billion in 1986.

U.S. GROSS ACTIVITY IN
FOREIGN EQUITIES

	<u>Gross Activity</u> (\$ Bil.)	<u>As % of Foreign Activity in U.S. Equities</u>
1986	\$101.3	36.5%
1985	45.6	28.7
1984	30.4	24.5
1983	30.3	22.6
1982	15.7	19.6
1981	18.8	24.9
1980	17.9	23.8
1975	3.3	12.7
1972	4.7	17.7

Source: U.S. Treasury

The numerous Euroequity offering and privatizations will surely lead to an increased appetite for foreign equities. Recent decisions by the SEC will, under certain conditions, allow greater participation in the international portion of non-U.S. privatizations by sophisticated U.S. investors and U.S. citizens resident in the foreign country of the privatized issue.

A recent survey by the NYSE substantiates this point. According to the exchange, the number of registered representatives and sales offices outside the U.S. increased in 1986 by 13% and 5%, respectively. Moreover, the table on the following page indicates that NYSE full-time producing RRs have increased their presence overseas for 13 consecutive years, with particularly heavy growth commencing in 1979.

**DISTRIBUTION OF NYSE MEMBER
FIRM SALES OFFICES AND RRS OVERSEAS**

	<u>Sales Offices</u>	<u>Full-Time Producing RRs</u>
1986	280	2,987
1985	268	2,653
1984	N/A	N/A
1983	252	2,286
1982	255	2,233
1981	254	1,996
1980	247	1,733
1979	227	1,698
1978	224	1,369
1977	214	1,314
1976	199	1,178
1975	216	1,039
1974	243	N/A
1973	279	N/A
1972	256	N/A

N/A Not Available

Source: New York Stock Exchange

PENSION FUND FLOWS

U.S. pension fund investment abroad has exploded and all signs indicate this growth will be continued. Data from InterSec Securities, an international investing consulting organization, shows that the portion of U.S. pension funds that invest in the U.S. has grown about 20% per year for the past five years. In comparison, the portion of U.S. pension funds that invest abroad have increased slightly over 50% per year. This explains in great part why U.S. securities firms have devoted considerable resources to building up a research capability in the coverage of foreign securities.

Finally, the growth of U.S. broker-dealers in such markets as London is due, in part, to the increase in pension flows overseas following the removal of U.K. foreign exchange controls in 1979. In the period 1979 to 1985 the "annual flow of U.K. investors' portfolio investment overseas increased from £1 billion to £18 billion and over 90% was done by overseas brokers."^{2/} As other countries continue to remove exchange controls, U.S. broker-dealers will have further reason to increase their overseas capabilities.

^{2/}London Stock Exchange Quarterly, Spring 1987, p.15.

**U.S. PRIVATE PENSION
ASSETS**
(\$ Billions)

	<u>Non-Domestic Assets</u>	<u>% of Total Assets</u>
1990(E)	\$130	8%
1986	45	4
1985	27	3
1980	3	1
1975	0	0

(E) Estimate

Source: InterSec Research Corp.

**IMPORTANCE OF FOREIGN MARKETS
FOR U.S. ISSUERS**

Perhaps the most dramatic trend in U.S. broker-dealers developing their international expertise has been the need of U.S. issuers, both public and private, to raise debt overseas.

While the reasons for U.S. overseas debt financing are many, perhaps none has had as great an impact as the huge economic imbalances among industrialized countries. This is particularly true of the huge U.S. deficits and the huge Japanese trade surpluses. With both U.S. government and private entities seeking (and competing for) funds, investment bankers have served as overseas intermediaries, bringing together borrowers and lenders. Technology has greased the wheels, allowing for the geographic separation of borrower and lender. That these lenders happened to be foreign, makes little difference to the borrowers. Indeed, if borrowers were not able to take advantage of overseas capital, U.S. interest rates would be higher.

The U.S. federal government has benefited greatly from foreign attraction to its debt. Indeed, foreign ownership of U.S. public debt securities held by non-bank investors stood at nearly 19% at the end of 1986. While the table indicates that foreign investors' share of U.S. debt holdings has generally declined over the past decade, this is more an indication of the increasing interest among other U.S. investors than waning of foreign interest. In addition, the U.S. government faces "competition" for foreign investors' dollars from the U.S. corporate market's increasing amount of debt which demands financing.

All this being said, the point still remains that foreign investors are still vitally important participants in the public debt markets; their absolute holdings have increased for seven consecutive years.

FOREIGN HOLDINGS OF FEDERAL DEBT
BY PRIVATE INVESTORS
(\$ Billions)

	Total Non-Bank Holdings	Foreign Holdings	
1986	\$1,371.9	\$255.6	18.6%
1985	1,225.0	214.6	17.5
1984	1,029.1	192.9	18.7
1983	833.8	166.3	19.9
1982	717.0	149.5	20.9
1981	583.1	136.6	23.4
1980	504.3	129.7	25.7
1979	452.4	119.0	26.3
1978	413.6	133.1	32.2
1977	362.4	109.6	30.2

Source: U.S. Treasury

CONCLUSION

In this paper, we have shown that, over time, the amount of funds raised internationally has increased significantly and the U.S. dominance in terms of the world's stock markets has declined dramatically. Foreigners have become important investors in all types of U.S. government and corporate securities, while, in turn, U.S. investors have become much more interested in foreign securities as investment vehicles. Both cyclical and secular reasons have contributed to create a "global village."

These developments have opened up opportunities for U.S. broker-dealers to serve as intermediaries in matching the needs of U.S. customers for capital with foreigners who are able to supply that capital. In seizing this opportunity, U.S. broker-dealers have expanded and established facilities in all parts of the world, and particularly in London and Tokyo. This phenomenon is well on its way and still developing.

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Senior Vice President and
Director of Research

David G. Strongin
Research Associate

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